APPENDIX

Opinion of the Court of Appeals

UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

No. 12,326

JEFFERSON STANDARD LIFE INSURANCE COMPANY, *Appellee*,

versus

UNITED STATES OF AMERICA, *Appellant*.

No. 12,327

JEFFERSON STANDARD LIFE INSURANCE COMPANY, *Appellant*.

versus

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JEFFERSON STANDARD LIFE INSURANCE COMPANY, *Appellee*,

versus

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No. 12,329

JEFFERSON STANDARD LIFE INSURANCE COMPANY, *Appellant*,

versus

UNITED STATES OF AMERICA, *Appellee*.

Appeals from the United States District Court for the Middle District of North Carolina, at Greensboro

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(Argued October 31, 1968 Decided March 13, 1969)

Before BRYAN and WINTER, Circuit Judges, and McMILLAN, District Judge.

Fred W. Peel and Wm. J. Adams, Jr. (Charles G. Powell, Jr.; Adams, Kleemeier, Hagan & Hannah, and Miller & Chevalier, on brief) for Jefferson Standard Life Insurance Company; Thomas L. Stapleton, Attorney, Depart-

ment of Justice (Mitchell Rogovin, Assistant Attorney General, Lee A. Jackson and Gilbert E. Andrews, Attorneys, Department of Justice, and William H. Murdock, United States Attorney, on brief) for United States of America; and Fred C. Scribner, Jr., Thomas C. Thompson, Jr., William C. Smith, David A. Sutherland, and Bruce A. Coggeshall; Scribner, Hall & Casey, and Pierce, Atwood, Scribner, Allen & McKusick on brief for American Life Convention and Life Insurance Association of America as Amici Curiae.

WINTER, Circuit Judge:

These appeals present myriad issues as to the application and interpretation of the Life Insurance Company Income Tax Act of 1959. 26 U.S.C.A. §§ 801, *et seq.*[1] For the taxable years 1958 and 1959 Jefferson Standard Life Insurance Company ("taxpayer" and sometimes "Jefferson") filed consolidated returns with its wholly-owned subsidiary Pilot Life Insurance Company ("Pilot"). After assessment and payment of taxes beyond those self-assessed, taxpayer filed timely suits for refund. From judgments favorable in part to taxpayer and favorable in part to the government, these appeals and cross-appeals for the two taxable years have been taken. We defer further statement on the facts until discussion of the issue to which they relate.

-I-

The Life Insurance Income Tax Act of 1959 was a comprehensive revision of the scheme of imposing income taxes on life insurance companies, other than mutual life insurance companies. In recognition that a part of the premiums charged, and a part of the income derived

[1] The Act added numerous sections to the Internal Revenue Code of 1954. Further references in this opinion will be to the Internal Revenue Code of 1954, as added by Pub. L. 86-69 and later amended, except where specifically noted.

from investments, will be repaid to policyholders at a future date, in satisfaction of a contractual obligation, the Act purports to tax only the portions of premium income and investment income which represent profit to the company, available legally for distribution to policyholders or stockholders as dividends, as distinguished from those gains which, under state law, must be set aside to meet the company's future contractual obligations. "In arriving at taxable investment income and gain from operations, the 1959 Act, consistent with prior law in this regard, recognizes that life insurance companies are required by law to maintain policy reserves to meet future claims, that they normally add to these reserves a large portion of their investment income and that these annual reserve increments should not be subjected to tax." *United States* v. *Atlas Life Ins. Co.*, 381 U.S. 233, 235-236 (1965). To accomplish this objective, "[t]he Act establishes a statutory framework directed to the measurement of life insurance company total income on an annual basis for use in the application of an annual tax." *Franklin Life Ins. Co.* v. *United States*, 399 F. 2d 757, 758 (7 Cir. 1968), *cert. den.*, U.S. , 37 L.W. 3320 (March 3, 1969).

The determination of the final tax base, to which ordinary corporate rates of taxation are applied, involves a series of multiple computations which may be referred to as "phases." Phase I involves the measurement and determination of taxable investment income. § 804. The computations incident to Phase I are, in the main, devoted to dividing up the investment income for the taxable year between a non-taxable "policyholders' share," deemed necessary for policyholder reserve obligations, and a taxable "life insurance company's share." The division is made up by dividing the company's "investment yield,"[2]

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[2] Investment yield is gross investment income, less specified deductions, including investment expenses, real estate expenses, depreciation, depletion and trade and business expenses, subject to certain exceptions and limitations. § 804(c).

by the assets of the company to produce an earnings rate. This rate, which is subject to a slight downward adjustment if the earnings rates in prior years are lower, is then multiplied by a figure representing the company's adjusted life insurance reserves[3] for policyholders. The product of the adjusted earnings rate and adjusted reserves equals the exclusion from taxes attributable to life insurance reserves.

The exclusion so obtained is then increased by additional sums attributable to special pension plan requirements and certain interest payments. The final total exclusion figure is referred to as total "policy and other contract liability requirements." § 805. The ratio of policy and other contract liability requirements to total investment yield constitutes the ratio upon which each and every item of investment yield is to be divided between the excludable policyholders' share and the company's share. The company's share constitutes the Phase I tax base.

The Phase II computation is directed to determining gain or loss from operations, and is intended to reflect the insurance company's income from *all* sources less certain specified deductions. These sources include premium or underwriting income. Premium income results when the price charged for the policy is in excess of the cost to the insurance company for providing the coverage, and such cost may be less than estimated, because actual mortality may turn out to be less than tabular mortality, and expenses incident to the sale and servicing of the policies may be less than estimated.

Under Phase II, all sources of company income are recognized. Items to be taken into account include the company's share of investment yield computed in a manner similar (but not identical) to its computation in Phase I. The essential difference is that, for purposes of Phase

[3] Life insurance reserves are the fund which, together with future premiums and interest, will be sufficient to pay future claims.

II, the interest rates assumed by the company in setting up its reserves are used, rather than the actual earnings rates used in Phase I. This assumed rate is multiplied by a figure representing not only life insurance reserves, but reserves set aside for supplementary contracts without life contingencies, dividend accumulations, premiums paid in advance and premium deposit funds. § 810(c). The result, referred to as the share of investment yield set aside for policyholders (or the "required interest"), is subtracted from total investment yield. The remainder constitutes the company's share of investment yield for purposes of Phase II and is includable in the tax base. Also included in the Phase II base are gross premiums, decreases in certain reserves and other amounts not relevant here. § 809(c). The sum of these items constitutes gross income for purposes of Phase II.

From gross income, certain specified deductions are allowed. § 809(d). These include deductions for underwriting expenses, salaries and other operating expenses, as well as charitable contributions. Also included are deductions for losses on insurance and annuity contracts, as well as for the company's share of tax-exempt interest and dividends received. Additionally, the company is allowed a deduction for increases in reserves during the taxable year. § 809(d)(2). When the various deductions are taken, the final result is the gain or loss from operations—the Phase II tax base.

Life insurance company taxable income consists of (1) the smaller of taxable investment income or the gain from operations, plus (2) 50% of the excess, if any, of gain from operations over taxable investment income,[4] to which

[4] This unique tax advantage—taxation of only one-half of income—was allowed by Congress in recognition of the difficulties of accurate establishment of insurance company annual taxable income and to compensate for the possibility that what may be considered taxable income in a given year may be required to fulfill a policy liability in a subsequent year. S. Rep. No. 291, 86th Cong., 1st Sess., p. 7 (1959—2 Cum. Bull. 770, 775).

is added any amount subtracted from the policyholders' surplus account.[5] § 802(b). This final amount is subject to taxes at normal corporate rates. § 802(a)(1).

We turn to the particular problems which these cases present arising from application of the framework thus summarized.

-II-

Prior to 1958, taxpayer acquired by purchase all of the outstanding stock of Pilot. During each of the years 1958 and 1959, Pilot paid cash dividends out of current earnings and profits to taxpayer in the amount of $1,250,000. For the years 1958 and 1959, these companies filed consolidated income tax returns. In both returns taxpayer and Pilot were treated as a single taxable entity. At every step in the computations required to determine the Phase I and Phase II taxable investment income, the figures for both companies were consolidated on an item-by-item basis, and there was eliminated from all computations the above-described investment of taxpayer represented by the Pilot stock, together with the dividends paid by Pilot to taxpayer.

The district court approved taxpayer's treatment of the consolidated returns and the elimination of the Pilot dividend. In this we think there was error, and on this issue we reverse.

Although the Act specifies how taxpayer's investment in other corporations and how dividends received by taxpayer from other corporations are to be treated, the Act makes no special provision for the treatment of dividends

[5] This amount constitutes distributions by the company to its stockholders in excess of amounts being taxed on a current basis. The method of computing this amount is specified in § 815. Since these cases present no question concerning computation of this amount, it need not be further described.

received by one life insurance company from its investment in another or the treatment of the investment of one life insurance company in another. Such a determination is, of course, crucial to the Phase I and Phase II computations which have been described.

The Treasury Regulations governing the filing of consolidated income tax returns antedate the Act. They provide that consolidated taxable income is the combined taxable income of the affiliated corporations and that the taxable income of each corporation shall be computed in accordance with the provisions covering the determination of taxable income of separate corporations except that "there shall be eliminated * * * dividend distributions from one member of the group to another member of the group." 26 C.F.R. § 1.1502-31A(b)(1)(i).[6]

While the Regulations establish the principle that intercompany dividends are to be eliminated, they do not establish how they are to be eliminated in the case of taxpayers under the Act, or, more specifically, at what stage of the Phase I and Phase II computations the elimination is to be made. We think that the answer is supplied by analogy to *United States* v. *Atlas Life Ins. Co., supra,* which considered a similar question in regard to tax-exempt interest on municipal bonds.

Before analyzing *Atlas,* we reiterate that the basic philosophy of the Act is to tax an insurance company only on

[6] This specific provision of the Regulation is subject, however, to the general reservation that "[a]ny matter in the determination of which the provisions of the regulations * * * are not applicable shall be determined in accordance with the provisions of the Code or other law applicable thereto." 26 C.F.R. § 1.1502-3A. Manifestly, this reservation should be given wider latitude where, as here, the Regulation preceded the Act and the Act made fundamental changes in the mode of taxing life insurance companies. In any event, a regulation inconsistent, in whole or in part, with the Congressional language cannot stand, to the extent of the inconsistency.

the portion of its investment income not required to be set aside in a reserve for future policy liabilities. If Pilot's dividend to taxpayer is to be eliminated at the outset of the Phase I and Phase II computations, in effect, the Act would be construed as if liabilities to taxpayer's policyholders were to be satisfied solely by other income. Such a result does not comport with fact because both taxpayer's investment in Pilot and the income derived therefrom are available and legally liable for the satisfaction of taxpayer's liabilities to its policyholders.

Atlas approved the concept that tax-free income was to be afforded its immunity only to the extent of the "life insurance company's share," and that such immunity did not extend to the "policyholders' share," otherwise nontaxable. True, *Atlas* reached this result under sections of the Act which specifically deemed the interest on municipal bonds tax-free, but it did so in a context in which there was a colorable argument that the interest *constitutionally* was tax-free. We think that the same reasoning applies where, as here, the tax-exempt feature is supplied by the Regulation.

To turn specifically to *Atlas*, the questions presented were how to treat interest on municipal bonds which was rendered tax-free in the computation of taxable investment income by § 804(a)(6), and in the calculation of gain from operation by § 809(b)(4).[7] A second question presented was whether such treatment violated any implied constitutional immunity of interest on municipal bonds from income taxes. In arriving at its result, the Court pointed out that Congress properly treated a major portion of investment income not as income to a life insurance company,

[7] Both §§ 804(a)(6) and 809(b)(4) specifically preserved the general exemption afforded interest on municipal bonds contained in § 103.

but as income to the policyholders.[8] The Court then went on to approve the Act's allocation of a share of tax-free interest to the policyholders, with recognition of its tax-free character of only that part of the interest on municipal bonds which was allocated as the "life insurance company's share."[9] Thus, *Atlas* held that interest income which was

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[8] "An insurance company obtains most of its funds from premiums paid to it by policyholders in exchange for the company's promise to pay future death claims and other benefits. The company is also obligated to maintain reserves, which, if they are to be adequate to pay future claims, must grow at a sufficient rate each year. The receipt of premiums necessarily entails the creation of reserves and additions to reserves from investment income. Thus the insurance company is not only permitted to invest, but it *must* invest; and it *must* return to the reserve a large portion of its investment income. As no insurance company would deny, there is sufficient economic and legal substance to the company's obligation to return a large portion of investment income to policyholder reserves to warrant or require the exclusion of investment income so employed from the taxable income of the company. And we think the policyholders' claim against investment income is sufficiently direct and immediate to justify the Congress in treating a major part of investment income not as income to the company but as income to the policyholders". 381 U.S., at 247-248 (emphasis in original).

[9] "Under the 1959 Act this portion is arrived at by subjecting each dollar of investment income, whatever its source, to a pro rate share of the obligation owed by the company to the policyholders, from whom the invested funds are chiefly obtained. In our view, there is nothing inherently arbitrary or irrational in such a formula for setting aside that share of investment income which must be committed to the reserves. Undoubtedly policyholders have not contracted to have assigned to them either taxable or exempt dollars. Their claim can be fully satisfied with either, but it runs against all investment income, whatever its source. We see no sound reason, legal or economic, for distinguishing between the taxable and non-taxable dollar or for saying that the reserve must be satisfied by resort to taxable income alone. Interest on municipal bonds may be exempt from tax, but this does not carry with it exemption from the company's obligation to add a large portion of investment income to policyholder reserves." (footnote eliminated.) 381 U.S., at 249.

exempt from taxation was exempt only to the extent that it constituted income to the life insurance company otherwise subject to tax.

The rationale of *Atlas* is that the two formulae for determining the policyholders' share exclusion constitute only a measurement for tax purposes of the claim of each company's policyholders against its investment income. In applying these formulae, the tax-exempt character of the income is not recognized at the outset of the computation, but is recognized at its conclusion, when the life insurance company's share of investment income is determined. A life insurance company receives special and substantial tax benefit, based upon the concept of the division of its income in accordance with its own relationship to its policyholders. As a corollary, all of its investment income—intercorporate or otherwise—is to be taken into account in computing the investment income and assets to which the policyholders of the life insurance company may look. We hold, therefore, that the intercorporate distributions rendered nontaxable by the regulation are only those intercorporate distributions which constitute a portion of the insurance company's share of investment income after the full intercorporate distribution has been included in the computation from which that share is determined.

- III -

Taxpayer and Pilot made charitable contributions during the tax years in question. Both allocated the contributions between the investment and underwriting functions—the Phase I and Phase II computations. While the government does not challenge the reasonableness of the allocations, the government asserts that the entire amount of charitable contributions should have been deducted in the computation of underwriting income and no part was deductible as an investment expense.

The district court sustained taxpayer's position. We disagree, and on this issue of the case, we also reverse the district court.

While § 804(c)(1) broadly permits the deduction, *inter alia,* of "investment expenses" [10] from gross investment income in determining "investment yield," § 804, overall, makes no specific mention of the deductibility of charitable contributions in determining taxable investment income—the Phase I computation. By contrast, § 809, which prescribes the Phase II computation—the determination of underwriting income or gain or loss from operations—specifically allows, *inter alia,* the deduction from the gross amount of premiums, etc., of "all other deductions allowed under this subtitle for purposes of computing taxable income to the extent not allowed as deductions in computing investment yield" in the determination (§ 809(d)(12)) of "gains from operations." Section 809(d)(12) is, in turn, modified by § 809(e)(3), which states that the limit in applying § 170—the general statute allowing deductions for charitable contributions—"shall be 5 percent of the gain from operations" computed without regard to certain items not relevant here. Without more, a comparative reading of these statutes leads to the inference that Congress intended that charitable deductions be recognized—and recognized solely—in the computation of gain from operations and not recognized in the computation of the life insurance company's share of investment income.

To escape this result, taxpayer advances three arguments, none of which we think possesses merit. First, we do not find persuasive the argument, which taxpayer seeks to bolster by reference to *New World Life Ins. Co.* v. *United States,* 26 F.S. 444 (Ct. Cl. 1939), *aff'd.,* 311 U.S. 620 (1940), that charitable contributions are "general expenses." Prior to the enactment of the 1939 Internal

[10] Section 804(c)(1) adds: "If any general expenses are in part assigned to or included in the investment expenses, the total deduction under this paragraph shall not exceed * * *." The Regulations define "general expenses," generally, as "any expense paid or incurred for the benefit of more than one department of the company * * *." 26 C.F.R. § 1.804-4(b)(1)(ii).

Revenue Code, charitable contributions were considered general expenses, but with the enactment of that Code, they were excluded from the category of expenses otherwise deductible as ordinary and necessary business expenses and made the subject of separate treatment. *Jefferson Mills, Inc.* v. *United States*, 259 F.S. 305, 311 (N.D. Ga. 1965), *aff'd. per curiam*, 367 F. 2d 392 (5 Cir. 1966).

That under current law a charitable deduction is a charitable deduction and not a general expense is the stumbling block which destroys taxpayer's second argument that charitable deductions are not controlled solely by § 809(d)(12) because that section purports to apply only to deductions "to the extent not allowed as deductions in computing investment yield." The implied exclusion in § 809(d)(12) is meaningless here, because there is no basis to say that a charitable deduction is allowable under § 804, the investment yield provision. The "to the extent, etc." language, rather than implying that something allowable under it must also be allowable under § 804, means simply that an item allowed under other provisions may not be allowed a second time under it.

Taxpayer's third argument is that allocation of charitable deductions between gross investment income and gross gain from operations is recognized by the method of accounting prescribed by the National Association of Insurance Commissioners (NAIC) in accordance with which taxpayer makes reports to the states which regulate its operations and which taxpayer followed strictly in preparing its tax returns for the years in question. This argument is also made with regard to other issues in these cases and merits full consideration.

The district court held that the "form of the Annual Statement prescribed by N.A.I.C. may only be used * * * in computing taxable income when it does not conflict with an accrual method of accounting and is not inconsistent with the provisions of the Internal Revenue Code or the

regulations thereunder." To like effect is *Franklin Life Ins. Co.* v. *United States, supra,* at p. 760. We think the district court was correct.

Section 818(a) permits resort to methods of *computation* as approved by NAIC for required annual statements provided that the computations be made on an accrual basis or another method fixed by the Regulations combining the accrual and other forms of accounting (and except the cash receipts and disbursement method).[11] Nothing in the legislative history of § 818(a) indicates that annual statement computations have other than a limited role—that they may be used only when "not inconsistent with the provisions of the 1954 Code and an accrual method of accounting."[12] A text writer is candid in admitting, as a general proposition, that there "are several areas where differences exist between the accrual basis used for the annual statement and the general rules of accrual for tax purposes" because "the emphasis of the annual statement

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[11] "§ 818. Accounting provisions

(a) Method of accounting.—All *computations* entering into the determination of the taxes imposed by this part shall be made—

(1) under an accrual method of accounting, or

(2) to the extent permitted under regulations prescribed by the Secretary or his delegate, under a combination of an accrual method of accounting with any other method permitted by this chapter (other than the cash receipts and disbursement method).

Except as provided in the preceding sentence, all such computations shall be made in a manner consistent with the manner required for purposes of the annual statement approved by the National Association of Insurance Commissioners." (emphasis supplied.)

[12] H. Rep. No. 34, 86th Cong., 1st Sess., p. 42 (1959-2 Cum. Bull. 736, 766); S. Rep. No. 291, 86th Cong., 1st Sess., pp. 72-73 (1959-2 Cum. Bull. 770, 823).

has been on the solvency of the company."[13] And the life insurance industry itself has recognized that the differences are so marked that revision of the annual statement blanks to conform to tax accounting concepts is precluded.[14]

We think that the conclusion in *Franklin Life* with regard to "loading" is equally applicable to charitable deductions:

> "The careful and detailed attention given by Congress throughout Sections 801 through 820 to definition of the particular items utilized as factors in the tax formula *and in specifying and enumerating the permissible deductions and exclusions negates the existence of any intent on the part of Congress to relegate the substantive matter* of offsetting or excluding loading on deferred and uncollected premiums, with its concomitant impact on the resulting tax, *to the NAIC.*" (emphasis supplied.) *Franklin Life Ins. Co.* v. *United States, supra,* p. 760.

We thus conclude that the NAIC form cannot create an extra-statutory deduction for charitable contributions.

- IV -

Taxpayer and Pilot "strengthened" all life reserves in the year 1959. This is to say, the reserves for life insurance policies were increased. Increases in life insurance company reserves may be attributable to additions required when a method or assumption used by the insurance company is changed so as to produce a higher reserve, as well as normal additions made each year to meet existing and increasing obligations under policies in force. It was

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[13] Denny and Rua, *Federal Income Taxation of Insurance Companies* (1961), p. 9.3.

[14] II Proceedings of the National Association of Insurance Commissioners (1963), pp. 445-447.

the former method, commonly called "reserve strengthening," which taxpayer and Pilot pursued.

The 1959 reserve strengthening included nonparticipating contracts, which are life insurance contracts in which the policyholders do not participate in company earnings or receive dividends.

At issue is the question of what portion of the reserve strengthening for nonparticipating contracts for 1959 is deductible in that year in the computation of gain or loss from operations (the Phase II computation). The question arises because § 809(d)(5) permits, so far as relevant here, the deduction from gross gain for operations of 10% of the increase for the taxable year in the reserves for nonparticipating contracts.[15] Section 810(d) establishes the

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[15] The text of the language of § 809(d)(5) permitting the deduction from gross gain from operations is as follows:

> "(5) Certain nonparticipating contracts.—An amount equal to 10 percent of the increase for the taxable year in the reserves for non-participating contracts or (if greater) an amount equal to 3 percent of the premiums for the taxable year (excluding that portion of the premiums which is allocable to annuity features) attributable to nonparticipating contracts (other than group contracts) which are issued or renewed for periods of 5 years or more. For purposes of this paragraph, the term 'reserves for nonparticipating contracts' means such part of the life insurance reserves (excluding that portion of the reserves which is allocable to annuity features) as relates to nonparticipating contracts (other than group contracts). For purposes of this paragraph and paragraph (6), the term 'premiums' means the net amount of the premiums and other consideration taken into account under subsection (c)(1)."

It will be noted that ¶ 5 states the permissible deduction as the greater of 10% in the reserves or 3% of the premiums attributable to the increase in the reserves. In this case, it is not disputed taxpayer and Pilot are entitled to use only the measure of 10% of the increase in the reserves.

so-called "spread rule," and it requires that certain increases in reserves may be taken into account only to the extent of 1/10th of the increase for each of the *succeeding* ten taxable years following the year in which the increase is experienced.[16] Thus, to be decided is the question of whether § 810(d) is applicable to the special situation for which provision is made in § 809(d)(5), or whether § 809 (d)(5) is to be applied without reference to § 810(d).[17]

The district court concluded that the § 809(d)(5) deduction based upon 10% of increase in reserves for non-

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[16] The text of ¶ 810(d) is as follows:

"(d) Adjustment for change in computing reserves:

(1) In general.—If the basis for determining any item referred to in subsection (c) as of the close of any taxable year differs from the basis for such determination as of the close of the preceding taxable year, then so much of the difference between—

(A) the amount of the item at the close of the taxable year, computed on the new basis, and

(B) the amount of the item at the close of the taxable year computed on the old basis as is attributable to contracts issued before the taxable year shall be taken into account for purposes of this subpart as follows:

(i) if the amount determined under subparagraph (A) exceeds the amount determined under subparagraph (B), *1/10 of such excess shall be taken into account, for each of the succeeding taxable years, as a net increase to which section 809(d)(2) applies;* or

(ii) if the amount determined under subparagraph (B) exceeds the amount determined under subparagraph (A), 1/10 of such excess shall be taken into account for each of the 10 succeeding taxable years, as a net decrease to which § 809(c)(2) applies." (emphasis supplied.)

[17] The Regulations, 26 C.F.R. § 1.809-5(a)(5)(b)(iii) require that 10% of the increase resulting from the strengthening of reserves for nonparticipating contracts be amortized over a ten-year period as required by § 810(d).

participating contracts is not subject to the § 810(d) "spread rule" to the extent that such increase was attributable to reserve strengthening.[18] We think the district court was correct.

At the outset, we note that § 809(d)(5) makes no reference to § 810. By contrast, § 809(d)(2), which permits deductions for the "net increase in reserves" limits the deduction to that "required by section 810 to be taken into account for purposes of this paragraph." Manifestly, § 810(d) refers to all types of increases in reserves, and is not limited to the strengthening of reserves *for nonparticipating contracts.* Hence, as a matter of statutory construction, § 810 may, but need not, refer to § 809(d)(5) and, if § 810 is held not to apply to § 809(d)(5), the former is not rendered nugatory.

From the reference in § 809(d)(2) to § 810, and the absence of such a reference in § 809(d)(5), we conclude that the "spread rule" prescribed by § 810(d) is not applicable to the special deduction for strengthening reserves for nonparticipating contracts permitted by § 809(d)(5). Our conclusion is supported by the legislative history of § 809(d)(5). In regard to it, the Senate Finance Committee stated its support of the proposal, which originated in the House, as follows:

> "Policyholder dividends in part reflect the fact that mutual insurance is usually written on a higher initial premium basis than nonparticipating insurance, and thus the premiums returned as policyholder dividends, in part, can be viewed as a return of redundant premium charges. However, such amounts provide a 'cushion' for mutual insurance companies which can be used to meet various contingencies. To have funds equivalent to a mutual company's redundant premi-

[18] The holding of the district court invalidated the portion of the Regulations referred to in footnote 17, *supra.*

ums, stock companies must maintain relatively larger surplus and capital accounts, and in their case the surplus generally must be provided out of taxable income. To compensate for this, the House bill allows a deduction for nonparticipating insurance equal to 10% of the increase in life insurance reserves attributable to nonparticipating life insurance (not including annuities). Your committee has recognized the validity of the reasons for providing such a deduction and has therefore continued it in your committee's version of the bill. . . ." S. Rep. No. 291, 86th Cong., 1st Sess., (1959-2 Cum. Bull. 786).

An earlier significant statement contained in the report follows:

> "Thus, a special 10 percent reduction is allowed with respect to the reserves on nonparticipating life insurance business (or, alternatively, a deduction of 3 percent of the premiums on these policies). This deduction is designed to compensate stock life insurance companies for the fact that they do not have the 'cushion' of redundant premiums (which, if the business does not go well), a mutual company can use to offset losses but otherwise are subsequently paid back as policyholder dividends)." S. Rep. No. 291, 86th Cong., 1st Sess. (1959-2 Cum. Bull. 778).[19]

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[19] An apparently conflicting statement was also contained in the report. As cited by the government, the report discussed reserves strengthening or weakening, and said:

> "8. Reserves strengthening or weakening.—A special spread rule is applied under the House bill and your committee's bill where a company determines that its reserves require strengthening and additions are therefore made to its reserves. If no limitations were imposed in these cases, the company could take a substantial additional deduction in computing gain or loss from operations for the year when the reserves were strengthened. To spread the effect of such adjustments, it is

Income tax laws are not always designed with the same reasons and logic brought into play in other branches of the law, such as the test of the reasonable man in the law of torts, but reason and logic support the result which we reach. If increases resulting from the strengthening of reserves for nonparticipating contracts were held subject to § 810, the amount deductible in any year following that in which the increase was experienced would be 1/10th of the 10% of such increase rendered deductible by § 809(d)(5). Yet, in the case of other increases in reserves, including increases from the strengthening of reserves for participating contracts, the full amount of the increase would be deductible over a period of ten years. It would seem more reasonable to us that if Congress concluded to permit only 10% of the increases in reserves from nonparticipating contracts to be deductible, there would be little need for application of the spread rule. Therefore, reason would seem to indicate that the spread rule was to come into play only when the deduction was more substantial in nature. Especially is this so when Congress appeared to be concerned with the redundancy in the premiums charged by mutual insurance companies and their ability to reduce their tax obligations as compared to a stock company which would need real incentive to strengthen reserves at the expense of its surplus.

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provided that, in the case of reserve strengthening, deductions relating to the additions in reserves are to be taken into account ratably over a 10-year period instead of entirely in the year of change. Conversely, in the case of reserve weakening, the increases in income relating to the reductions in reserves are to be taken into account over a 10-year period." S. Rep. No. 291, 86th Cong., 1st Sess. (1959-2 Cum. Bull. 794).

The quoted language does not purport to be confined to strengthening of reserves for nonparticipating contracts. Indeed, it does not even employ the phrase. A reading of the report as a whole leads us to conclude that the quoted language referred to strengthening or weakening reserves generally and was not intended to override or limit the discussion of special treatment of strengthening reserves for nonparticipating policies quoted in the text.

- V -

When taxpayer filed consolidated income tax returns with Pilot, its wholly-owned subsidiary, for the years 1958 and 1959, it computed its tax according to the rates specified in the corporate income tax returns for life insurance companies. Those rates were 2% higher for life insurance companies filing consolidated returns than for life insurance companies filing separate returns. At a later date, taxpayer took the position that life insurance companies are entitled to file consolidated returns without payment of the 2% higher rate. This legal issue was resolved against taxpayer by the district court, and we think correctly so.

Section 802(a)(1), before it was amended in 1964,[20] imposed a tax on the taxable income of every life insurance company and provided that "[s]uch tax shall consist of—(A) a normal tax on such income computed at the rate provided by section 11(b), and (B) a surtax, on so much of such income as exceeds $25,000, computed at the rate provided by section 11(c)." Section 11 is divided into several subsections. Section 11(a) imposes a tax "for each taxable year on the taxable income of every corporation. The tax shall consist of a normal tax computed under subsection (b) and a surtax computed under subsection (c)." Section 11(c) prescribes that the surtax shall be "equal to 22 percent of the amount by which the taxable income * * * exceeds $25,000." Section 11(d) spe-

[20] Section 802(a)(1) was amended by the Revenue Act of 1964, § 235(c)(1), 78 Stat. 126, and presently provides, in pertinent part, that the tax upon life insurance company taxable income "shall consist of a normal tax and surtax computed as provided in section 11 as though the life insurance company taxable income were the taxable income referred to in section 11." The legislative history of this revision refers to it merely as a "technical amendment." H. R. Rep. No. 749, 1 U. S. Code Cong. & Ad. News, p. 1639 (1964). Thus, the 1964 amendment sheds little light upon the proper interpretation of the pre-1964 version of § 802(a)(1) with which we are herein concerned.

cifically excepts from the application of § 11(a) corporations subject to a tax imposed by §§ 801, *et seq* (life insurance companies). However, for the years in question[21] § 1503 provided that in any case in which a consolidated return was made or required to be made "* * * the tax imposed under section 11(c) * * * shall be increased for any taxable year by 2 percent of the consolidated taxable income of the affiliated group of includible corporations."

The basic argument advanced by taxpayer is that, since § 1503 refers to the tax "imposed under section 11(c)" and since the tax upon life insurance companies is *imposed* by § 802, with only a cross-reference to § 11(c) to determine the manner of computation, the taxpayer does not fall within the "tax imposed under section 11(c)" language of § 1503 for purposes of the additional 2% tax.

Literal acceptance of taxpayer's argument would render § 1503 a complete nullity because § 11(c) does not *impose* the surtax; the surtax is imposed by § 11(a) and § 11(c) merely states the method of computation of its amount. We do not find convincing the government's argument that "imposed under section 11(c)" is broader than the more usual language of "imposed by" and no authority to support this conclusion is cited. *Cf., United States* v. *Wigglesworth,* 28 Fed. Cas. 595, 596, No. 16,690 (Cir. Ct. D. Mass. 1842). Overall, however, we think that the arguments on this point are overtechnical and overrefined.

The basic purpose of enactment of the Act was to establish "a statutory framework directed to the measurement of life insurance company total income on an annual basis for use in the application of an annual tax." *Franklin Life Ins. Co.* v. *United States, supra.* Substantial concessions were made to life insurance companies to insure that only income not presently or prospectively needed to

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[21] The 2% increase in surtax was eliminated in 1964 by Pub. L. 88-272, § 234(a).

meet policy liabilities would be taxed, but with respect to life insurance company taxable income the intent of Congress that life insurance companies be taxed at the same rate as other corporations was oft expressed. Both the House and Senate Reports emphasize that the rate of tax on life insurance companies was to be "a normal tax on such income, computed at the regular corporate normal tax rate provided by section 11(b) of the 1954 Code, and * * * a surtax * * * computed at the regular corporate surtax rate provided by section 11(c)."[22] Indeed, the Congressional intent could not be more clearly stated than as set forth in Senate Report No. 291, 86th Cong., 1st Sess., p. 127 (Supplemental Views on H. R. 4245):

> "After a determination of the proper tax base, the life insurance company would be taxed on its corporate profits *at current rates as is any other corporation. To do less would be unfair to other taxpayers who would be thus required to bear a disproportionately greater share of the tax burden.*" (emphasis supplied.)

We conclude that the only reasonable overall interpretation of the statutory language is that when the surtax imposed by § 11 on ordinary business corporations was increased by § 1503, that increase was equally applicable to life insurance companies by virtue of the provisions of § 802(a)(1). It seems to us that the cross-reference to § 11(c), the computation subsection of § 11, contained in § 1503, indicates that the increase in rates provided for in § 1503 was applicable to any taxpayer for which the rates of tax previously established by § 11(c) were applicable. Taxpayer was within that group. Certainly, the legislative history of § 802(a)(1) does not indicate that taxpayer was to receive treatment any different, and specifically, taxed

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[22] H. Rep. No. 34, 86th Cong., 1st Sess., p. 23 (1959-2 Cum. Bull. 736, 752); S. Rep. No. 291, 86th Cong., 1st Sess., p. 44 (1959-2 Cum. Bull. 770, 802).

at any different rate, from that afforded non-life insurance company taxpayers. Equally certain, § 1503 should not be rendered meaningless in regard to all classes of taxpayers.

–VI–

We are next concerned with whether, in determining gain from operations under § 809, taxpayer may take a deduction for "increase in loading on deferred and uncollected premiums," and whether, in determining investment income under §§ 804 and 805, taxpayer is entitled to exclude "loading on deferred and uncollected premiums" from its assets.

The gross annual contract premium, which is the beginning point for computing "gain from operations" under § 809, is the amount paid by an insured to the taxpayer for coverage for a full policy year. The gross contract premium is made up of two parts, a net valuation portion and a loading portion. The net valuation portion (sometimes called the net valuation premium) is the amount which, on the basis of legally required interest and mortality assumptions, is estimated to be required each year for reserves for policyholder claims. The difference between net valuation premium and the gross contract premium is referred to as the "loading." A purpose of loading is to pay for expenses incurred in writing and caring for the policy and to provide a margin for possible contingencies.

Although many insureds pay their gross contract premium in one lump sum annually, it is not unusual for an insured to pay the gross contract premium in semi-annual, quarterly or monthly installments over the policy year. As a result, portions of gross contract premiums may remain outstanding and not as yet received by taxpayer as of the end of the taxable year. Deferred payments are the portions of gross contract premiums on policies with premiums payable in installments that become due after December 31 of the calendar year and before the next policy anniversary date. Uncollected premiums are annual or installment pre-

miums which, as of December 31 of a calendar year, have become due but have not as yet been paid. Usually the insured has a 31-day grace period after the due date in which to make payment and retain his rights under the policy.

Taxpayer does not have a legal right to collect the portions of gross contract premiums referred to as deferred and uncollected. If the insured fails to make payment, however, the insurance coverage lapses. The life insurance reserves on taxpayer's policies are computed on the assumption that on each policy anniversary date the full annual gross contract premium has been received. This assumption is applied to policies having deferred and uncollected premiums. Taxpayer assumes it has a full year's liability for insurance coverage under these policies and credits the reserves which are reflected for tax purposes with the entire annual net valuation premium.

For purposes of the NAIC form, taxpayer includes in premium income the gross contract premiums on policies in force, including the deferred and uncollected portions thereof, but it deducts all annual costs incurred in servicing the policies and thereafter takes a further deduction for "increase in loading on deferred and uncollected premiums." On its federal tax returns taxpayer proceeded by the same method. The deduction was denied by the Commissioner and disallowed by the district court.

For purposes of the NAIC form, taxpayer included in assets only the gross contract premium net of the loading on the uncollected portion, i. e, the deferred net valuation portion of the gross contract premium. The district court, however, held that the taxpayer is required, for purposes of §§ 804 and 805, to treat the entire gross contract premium as an asset without any reduction for "increase in loading" on deferred and uncollected premiums.

We affirm the district court. In *Franklin Life Ins. Co. v. United States, supra,* it was held that for purposes of

§§ 804 and 805 the taxpayer was required to compute "investment income" by including deferred and uncollected premiums (including loading) in its assets. But see, *Western Nat. Life Ins. Co.* v. *Commissioner*, 50 T. C. 285 (1968).[23] This conclusion stemmed in part from the Court's holding that in computing "gain from operations" in accordance with § 809 the taxpayer was obliged to include deferred and uncollected premiums (including loading) in gross premiums, because Congress would not be presumed to have contemplated a dual standard of tax accounting. The conclusion with regard to § 809 was based in large part on taxpayer's concession that "the intent and purpose of the Act require that the deferred and uncollected premiums be included in income on a gross basis (which includes loading)" coupled with the failure of Congress in enumerating deductions from gross income to authorize any deduction for loading.

Taxpayer has not made the concession made in *Franklin Life* and it vigorously contends that for that reason the holding in that case is not only distinguishable but also incorrect. It asserts that the failure of Congress to author-

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[23] In *Western Nat. Life Ins. Co.* v. *Commissioner*, 50 T. C. 285 (1968), the court held that deferred and uncollected premiums should be excluded entirely from assets for purposes of the computations required by §§ 804 and 805 on the theory that only such assets which actually produced investment income, as opposed to mere bookeeping entries, should be included.

At the behest of the Commissioner and in response to *Franklin Life*, the Tax Court once again entered upon what it described as "this fantasy world of life insurance company accounting and taxation." The result was a modification of the court's original views, which brings them into line with the position adopted by the taxpayer in the instant case. In particular, the Tax Court held that deferred and uncollected premiums *net of loading* should be included in assets. *Western Nat. Life Ins. Co.* v. *Commissioner*, 51 T. C. No. 81 (1969). For the reasons stated in the text, we adhere to the result reached in *Franklin Life* and by the district court.

ize a deduction for loading in § 809(d) is of no significance; rather, so the argument runs, the treatment of loading by the NAIC form, which has been the industry standard since 1951, is determinative and was accepted by Congress in enacting § 809(c).[24] In this connection, it is said that exclusion of loading is in the nature of an adjustment, not a deduction, and the failure of § 809(d) to make mention thereof unexceptional.

The question is not totally free from doubt, but we incline to the government's view. We have already stated our views with regard to the limited function of NAIC treatment in the taxation of life insurance companies. Section 809(c) does permit certain adjustments to gross premiums, but, significantly, it provides for no adjustment for loading. Certainly, § 809(d) provides no deduction therefor.

Taxpayer credits reserve liabilities for tax purposes with a full policy year's net valuation, even though it had not received (and had no legal right to receive) all of the premiums therefor, and it does not dispute that it was required to take into account that part of the gross annual premium (exclusive of loading) which was deferred and uncollected. Section 818(a) specifies an accrual basis method for reporting of life insurance company income. Presumably, taxpayer is not required to include in income amounts which it has not received or which it has no right to receive; similarly, it is not entitled to deduct an expense of liability which it has neither paid nor incurred. Symmetry would require, however, that both sides of the equation by which taxable income is determined be treated alike. Thus, if taxpayer treats its reserve liabilities for tax purposes with

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[24] A general statement of the Secretary of the Treasury to the effect that the starting point for measuring net earnings should be the figure appearing in each company's annual statement is cited in support, House Committee on Ways and Means, *Hearings on Taxation of Income of Life Insurance Companies*, 85th Cong., 2d Sess., p. 4 (1958).

a full year's net valuation (an item deductible under § 809(d)(2)), even though it had not received and had no legal right to receive all of the premiums therefor, it should be required to include gross annual premiums, including loading as the gross income figure under § 809(c)(1), without deduction for loading on deferred and uncollected premiums since § 809(d) provides no deduction therefor.

Similarly, gross premiums should be included in assets for purposes of the investment income formula under § 804. NAIC treatment is not determinative when the Act prescribes different treatment. If the full annual net valuation premium is treated as a reserve liability under § 804, the corresponding asset should be the gross annual premium (including loading); else the formula is unbalanced to the unwarranted benefit of taxpayer. The justness of this conclusion is recognized by the life insurance industry itself.[25]

Regulation 1.805-5(a)(4)(ii) Example (1), and Regulation 1.809-4(a)(1)(i), applicable to taxable years beginning after December 31, 1957, but not adopted until January 19, 1961, are in accord with the conclusions we reach in regard to the inclusion of gross premiums in assets for purposes of § 805, and the inclusion of gross premiums without deduction or adjustment for loading on deferred and uncollected premiums for purposes of § 809, respectively. Concluding as we do that the taxpayer in *Franklin Life* conceded no more than what the law required, we rely on the decision therein in support of our views.

–VII–

The *Franklin Life Insurance Company* case is also dispositive of the issues involving the treatment of interest on loans to policyholders.

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[25] Wightman, *Life Insurance Statements & Accounts* (1952), pp. 44-46.

By the terms of taxpayer's policy loan agreements a policyholder who borrows money from taxpayer in connection with a specific life insurance policy is required to pay the interest "annually in advance" on the policy anniversary date. In the event that an insured does not pay the annual interest as required on the due date, the policy loan agreement requires that the interest be capitalized and thus added to the principal of the loan, bearing interest thereafter at the agreed upon rate.

Taxpayer in its own records distinguished between interest deemed "earned" and interest deemed "unearned." Where a policy anniversary date with regard to a policy securing a loan fell at some portion of the year other than December 31, taxpayer adjusted its records as of December 31 to show what portion of the interest had been earned during the taxable year and what portion was unearned. If the annual interest was in default and had been added to the principal of the policy loan then, as of December 31, taxpayer would prorate the interest as of December 31 to show the amount earned to that date, deferring recognition of the balance for income purposes until the following year. In the event that the policyholder repaid the principal of the loan during the policy year taxpayer refunded the portion of the annual interest deemed unearned at that point to the policyholder; and where the amount deemed unearned had already been added to the policy loan principal, taxpayer, in the event of repayment of principal, credited the policyholder with the "unearned" portion of such interest.

On its tax returns for the years in suit, taxpayer, in computing its taxable investment income, sought to reflect only the interest it deemed "earned" as income, and to defer recognition as income of the remainder of the interest actually received or added to policy loan principal until the succeeding taxable year. The district court disallowed taxpayer's payment and held that both the full amount of

interest actually received and interest added to policy loan principal must be recognized as income in the years received or added to the principal.

We affirm on the authority of *Franklin Life Ins. Co.* v. *United States, supra.* See, in addition, *Schlude* v. *Commissioner,* 372 U.S. 128 (1963).

–VIII–

Whether agents' debit balances are to be treated as assets for purposes of § 805(b)(4) in the computation of taxable investment income is the next issue we must decide. Neither taxpayer nor Pilot treated agents' debit balances as assets for purposes of § 805(b)(4). The district court sustained the Commissioner's determination that they should have been included, and we affirm.

Agents' debit balances are the result of charges to the accounts of insurance agents made against future commissions. Jefferson did not make any cash advances to agents; Pilot, however, would advance money to its agents to provide for their living expenses until their commission income was sufficient to support them. Both Jefferson and Pilot also debited agents' accounts for various other charges, fees charged by reason of the cancellation or nondelivery of insurance policies within a specified time after they were written by the agent, charges for premiums on health and disability insurance on agents and their dependents, and, in the case of Jefferson, withholding taxes and charge-backs of commissions previously paid with respect to policies subsequently cancelled.

Although Jefferson, and apparently Pilot, had a contractual right to charge its agents interest on the amounts of the agents' debit balances, neither Jefferson nor Pilot did so. When an agent terminated his connection with the company at a time when a debit balance existed in his account, Jefferson and Pilot would apply commissions to which the agent subsequently became entitled against the

debit balances. After such application no attempt was made, however, to collect any remaining debit balance in the account from a former agent. When an agent left the employment of either company leaving a debit balance on his account and there were no further commissions due to that agent, each company charged the agent's uncollected balances to general insurance expenses. The large percentage of the debit balances of Pilot's agents represented amounts owed by agents who were still agents of Pilot at the end of the year, apparently because Pilot made cash advances to them. The NAIC annual statement calls for the amount of agents' debit balances to be shown as a nonadmitted asset.

Section 805(b)(4) defines the term "assets" to mean "all assets of the company (including nonadmitted assets), other than real and personal property (excluding money) used by it in carrying on an insurance trade or business." Section 805(b)(4) also provides that the amount attributable to real property and stock shall be the fair market value thereof and any other asset shall be valued at the adjusted basis (determined without regard to fair market value on December 31, 1958) of such asset for purposes of determining gain on sale or other disposition. Regulation § 1.805-5(a)(4)(i) defines the assets excludable because they are "used by the life insurance company in carrying on an insurance trade or business" as limited to (1) home office and branch office buildings owned and occupied by the life insurance company, (2) furniture and equipment owned by the life insurance company and used in the home office and branch office buildings occupied by the life insurance company, (3) supplies, stationery and printed matter used in the operations conducted in the home office and branch office buildings occupied by the life insurance company and (4) automobiles and other depreciable property used in connection with the operations conducted in the home office and branch office buildings occupied by the life insurance company. Thus, the regulation does not

treat agents' debit balances as assets of the company used by it in carrying on an insurance trade or business; indeed, the first example given to illustrate the application of the rule in § 1.805-5(a)(4)(ii) specifically includes agents' debit balances among other items of property which are "assets" as defined by § 805(b)(4), because they are *not* used in carrying on an insurance trade or business.

At the outset, we note that the conclusion of the district court is in accord with that of two other district courts which have considered the problem. *Western National Life Ins. Co.* v. *Commissioner,* 50 T.C. No. 28 (1968); *Franklin Life Ins. Co.* v. *United States,* 67-2 U.S.T.C. ¶ 9515 (S.D. Ill. 1967), rev'd. on other grounds, *Franklin Life Ins. Co.* v. *United States, supra.*

Aside from these decisions, it seems clear that agents' debit balances are assets of Jefferson and Pilot, and that § 805(b)(4) includes nonadmitted assets, which is how Jefferson and Pilot treat them. Except in the broadest sense, agents' debit balances are not accounts receivable used by an insurance company "in carrying on an insurance trade or business" and the legislative history of § 805(b)(4) would not support the broader meaning because, conceptually, the Phase I computation is not restricted to invested assets, but encompasses the total assets of a life insurance company and the portion thereof devoted to policy reserves.[26] If agents' debit balances are

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[26] H. Rep. No. 34, 86th Cong., 1st Sess., p. 12, fn. 1 (1959-2 Cum. Bull. 736, 744, fn. 1):

> "The company's earned rate actually is determined by dividing the company's 'investment yield' by its *total assets.*" (emphasis supplied.)

And at p. 10 (H. Rep. No. 34) and p. 743 (1959-2 Cum. Bull.):

> "Making use of a company's actual earnings rate in arriving at the reserve deduction in effect allocates investment income between life insurance reserves and surplus, according to the *total amount* of each." (emphasis supplied.)

treated as personal property used by an insurance company in carrying on an insurance trade or business, the command of § 805(b)(4) that the term "assets" means all assets of the company, other than certain exceptions, would be rendered meaningless because the exceptions would be construed so broadly as to include literally all assets, so that nothing would be left.

Regulation 1.805-5(a)(4) appears to take a reasonable position with regard to what assets constituting real and personal property are used by an insurance company in carrying on an insurance trade or business. The recent decision in *United States* v. *Correll*, 389 U.S. 299, 306-307 (1967), directs the course of our decision:

> "* * * we do not sit as a committee of revision to perfect the administration of the tax laws. Congress has delegated to the Commissioner, not to the courts, the task of prescribing 'all needful rules and regulations for the enforcement' of the Internal Revenue Code. 26 USC § 7805(a). In this area of limitless factual variations, 'it is the province of Congress and the Commissioner, not the courts, to make the appropriate adjustments.' Commissioner v. Stidger, 386 US 287, 296, 18 L ed 2d 53, 59, 87 S Ct 1065. The role of the judiciary in cases of this sort begins and ends with assuring that the Commissioner's regulations fall within his authority to implement the congressional mandate in some reasonable manner."

-IX-

Taxpayer established a Branch Office Manager's Supplemental Retirement Plan in order to provide supplemental pension benefits to branch office managers. Taxpayer made contributions based upon the employee's salary and such contributions were not set apart or treated as separate funds but remained a part of the general corporate funds of taxpayer. If the employee reached the age of 65 while

still in taxpayer's employ he was to receive an annuity. If the employee left taxpayer prior to age 65, died prior to age 65, becomes an agent or employee of another life insurance company at any time, including after retirement, or if taxpayer terminated his employment prior to that age, the employee had no right to any annuity nor to any part of taxpayer's contributions to the plan, irrespective of the number of years the employee belonged to the plan.

Taxpayer did not issue any actual annuity contracts to branch office managers upon their inclusion in the plan, although it did notify them of their rights under the plan and sent them annual reports of contributions made to the plan in their behalf. Taxpayer expressly reserved an "absolute and unconditional" right to terminate the employment of members of the plan, and also a right to modify or terminate the entire plan. Its right of modification or termination of the plan, however, did not permit it to affect the right of any employee to receive benefits accrued to his account under the plan prior to the effective date of such change or termination.

Because the category of employees included was not sufficiently broad (§ 401(a)(3)(A)), the plan did not meet the requirements of § 401, which provides that if a pension plan meets its requirements (1) income of the plan will be tax exempt and (2) the corporation may deduct its contributions within certain specified limitations.

The issue presented is whether taxpayer is entitled to treat a portion of the contributions made by it as "life insurance reserves," as defined under § 801(b)(1), so as to increase the policyholders' share exclusion under § 804 in the Phase I computation of the tax, as well as to increase the required interest exclusion and the deduction for increases in reserves under § 809 in the Phase II computation of the tax. The district court upheld the Commissioner's position that the amounts designated by taxpayer

for funding the plan did not qualify as life insurance reserves under § 801(b)(1), and we affirm.

Section 805(c)(1) defines "adjusted life insurance reserves"—one of the components, the earnings on which form part of the policyholders' share exclusion—as "other than pension plan reserves." Section 805(d)(1)(C) provides a special benefit for life insurance companies in that it expressly provides that reserves for pension plans *qualified under § 401* may be included as pension plan reserves in computing reserves for purposes of the policyholders' share exclusion, so as to increase the measure of the exclusion. Taxpayer's branch office manager plan is not included in the benefit established by § 805(d)(1)(C) since it is not qualified under § 401. It is hardly likely that an intelligible legislative purpose would be served in providing that reserves for an insurance company's own pension plan may be recognized in computing the policyholders' share only if the plan qualifies under § 401, if the same reserves are to be recognizable in any event as life insurance reserves. This is apparent, even though, as taxpayer argues, the exclusion of "pension plan reserves" in § 805(c)(1) must be read as meaning "pension plan reserves" for a plan qualified under § 401 as § 805(d)(1)(C) later defines the term.

A more basic consideration leading to our affirmance of the district court is the retrievable nature of the alleged pension plan reserves. Taxpayer can invade or take back the amounts it has set aside in divers situations, viz., the resignation of a covered employee before age 65, the death of a covered employee before age 65, and the discharge of a covered employee. Only where rights accrued to his account under the plan prior to the effective date of modification or termination was taxpayer restricted in treatment of the funds set aside; even then, or after retirement, all benefits are forfeited if a branch office manager becomes

an employee of any other life insurance company or sells life insurance for another company.

This restriction, however, is not sufficient to overcome the basic concept of the Act, that only amounts irrevocably put aside to meet certain future obligations to life insurance policyholders, and the earnings thereon necessary to augment the reserves for that purpose, should be rendered tax free. Unlike a true life insurance reserve, unilaterally taxpayer may terminate the employee relationship and the purported benefit has no cash surrender value. *Cf., Helvering* v. *Inter-Mountain Life Insurance Co.*, 294 U.S. 686 (1935); *New York Life Ins. Co.* v. *Bowers*, 283 U.S. 242 (1931); *General Life Ins. Co.* v. *Commissioner*, 137 F.2d 185, 189-190 (5 Cir. 1943); *Massachusetts Mutual Life Ins. Co.* v. *United States*, 56 F.2d 897 (Ct. Cl. 1932). Even if the benefit vests, it is defeasible under certain circumstances. The fact that some pension plans permit the cancellation of benefits under certain circumstances is irrelevant, because taxpayer seeks to sustain its treatment of the amounts set aside, not on the theory that it has a pension plan approved under § 401, but on the theory that it has established reserves which are life insurance reserves.

The judgments of the district court are reversed in part and affirmed in part, as stated herein, and the cases are remanded for entry of judgments consistent herewith.

AFFIRMED IN PART;
REVERSED IN PART;
AND REMANDED.

Judgments of the Court of Appeals

JUDGMENT

UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

No. 12,326.

JEFFERSON STANDARD LIFE INSURANCE COMPANY, *Appellee,*

vs.

UNITED STATES OF AMERICA, *Appellant.*

Appeal from the United States District Court for the Middle District of North Carolina.

This cause came on to be heard on the record from the United States District Court for the Middle District of North Carolina, and was argued by counsel.

On consideration whereof, It is now here ordered and adjudged by this Court that the judgments of the said District Court appealed from, in this cause, be, and the same is hereby, affirmed in part and reversed in part; that the case is remanded to the United States District Court for the Middle District of North Carolina, at Greensboro, for entry of judgment consistent with the opinion of the Court filed herein.

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JUDGMENT

UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

No. 12,327.

JEFFERSON STANDARD LIFE INSURANCE COMPANY, *Appellant*,

vs.

UNITED STATES OF AMERICA, *Appellee*.

Appeal from the United States District Court for the Middle District of North Carolina.

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JUDGMENT

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Findings of Fact and Conclusions of Law of District Court

[NOTE: The District Court did not write an opinion in these cases. There are appended the Court's Findings of Fact and Conclusions of Law]

IN THE UNITED STATES DISTRICT COURT
FOR THE MIDDLE DISTRICT OF NORTH CAROLINA
GREENSBORO DIVISION

No. C-66-G-63
No. C-194-G-63

JEFFERSON STANDARD LIFE INSURANCE COMPANY, a Corporation, *Plaintiff*,

v.

UNITED STATES OF AMERICA, *Defendant*.

* * * * * * * * * * *

STANLEY, *Chief Judge*

The plaintiff, Jefferson Standard Life Insurance Company, seeks by these actions to recover of the defendant, United States of America, Federal income taxes allegedly overpaid with respect to the years 1958 and 1959. In its answers, the defendant, in addition to denying liability to the plaintiff, asserts counterclaims with respect to additional income taxes assessed against the plaintiff for the years 1958 and 1959. The plaintiff, by replies timely filed, denies liability for the deficiency assessments asserted in the counterclaims.

The cases were tried by the Court without a jury. At the conclusion of the trial, the parties stipulated that, because of the numerous and complicated issues involved, and the interest of obtaining a decision at the earliest possible date, it would be agreeable for the Court to dispense with its customary practice of writing opinions in

non-jury cases, and confine its decision to findings of fact and conclusions of law.

The Court, after giving due consideration to the pleadings and the evidence, including exhibits and stipulations, the requests and briefs submitted by the parties, and oral arguments of counsel, now makes and files herein its Findings of Fact and Conclusions of Law, separately stated:

Findings of Fact

I

General Findings

1. The facts herein found are applicable with respect to the taxable years 1958 and 1959, except as otherwise stated or indicated.

2. Jefferson Standard Life Insurance Company (hereinafter referred to as "Jefferson"), and Pilot Life Insurance Company (hereinafter referred to as "Pilot"), are domestic stock life insurance companies duly incorporated and existing under the laws of the State of North Carolina, and engaged in business as life insurance companies as defined in § 801(a) of the Internal Revenue Code of 1954, as amended (hereinafter referred to as "the Code"). The principal office of Jefferson is located at Jefferson Square in the City of Greensboro, Guilford County, North Carolina, and the principal office of Pilot is located at Sedgefield, Guilford County, North Carolina.

3. Jefferson owns all the outstanding capital stock of Pilot, and Jefferson and Pilot duly elected to file consolidated income tax returns for the years 1958 and 1959.

4. Jefferson duly and timely executed and filed with the District Director of Internal Revenue for the District of North Carolina Federal income tax returns (the same being consolidated returns applicable to Jefferson and its

subsidiary, Pilot, as permitted by law), for the taxable (and calendar) year 1958, and for the taxable (and calendar) year 1959.

5. As provided by law, Jefferson's subsidiary, Pilot, duly consented to and authorized the filing of said consolidated income tax returns, and pursuant to applicable laws and regulations, Jefferson, both on its own behalf and as the duly authorized agent of its subsidiary, Pilot, was entitled to file in its sole name said consolidated income tax returns for the years 1958 and 1959, and to file in its sole name the claims for refund hereinafter mentioned.

6. Jefferson, both on its own behalf and as the duly authorized agent of its said subsidiary, Pilot, is entitled, in its sole name, to institute and prosecute these actions, and to receive the amounts of refund, if any, which the Court may adjudge to be due Jefferson in these actions.

7. Jefferson's tax return for the year 1958 reported a tax liability for said taxable year in the amount of $7,213,029.00, and this tax was duly and timely paid to the District Director of Internal Revenue for the District of North Carolina.

8. Jefferson's tax return for the year 1959 reported a tax liability for said taxable year in the amount of $7,280,350.00. However, of said reported amount, $292,906.00 represented Jefferson's liability for the transitional tax for the year 1957, arising under the provisions of § 818(e) of the Code. Thus, the amount of tax shown to be due by Jefferson's return for the year 1959, exclusive of said 1957 transitional tax, was $6,987,444.00. Under the mentioned statute, Jefferson is allowed to pay its 1957 transitional tax in ten equal annual installments. Accordingly, with respect to the year 1959, Jefferson duly and timely paid to the District Director of Internal Revenue for the District of North Carolina the amount of $6,987,444.00, plus $29,291.00 representing one-tenth of said

1957 transitional tax, or an aggregate amount of $7,016,735.00.

9. At all times referred to herein, the District Director of Internal Revenue for the District of North Carolina was the agent of the defendant duly authorized by law to accept and collect, on behalf of the defendant, payments of the aforementioned income taxes made by Jefferson and, consequently, payment of said income taxes to the said District Director of Internal Revenue for the District of North Carolina constituted a payment of said taxes to the defendant.

10. Jefferson duly filed, pursuant to the provisions of § 6511 and § 7422(a) of the Code, and within the time required by law, with the defendant, through its authorized agent, the District Director of Internal Revenue for the District of North Carolina, claims for refund for certain amounts paid to the defendant on account of Jefferson's income tax returns for the years 1958 and 1959, and for lawful interest thereon, and for such additional refund or other relief to which it might be lawfully entitled, and alleged by Jefferson to have been erroneously and illegally assessed against, and collected from, Jefferson by the defendant. These actions, based upon said claims for refund, were timely instituted.

11. By orders duly entered, the Court granted motions of the defendant to amend its answers by adding counterclaims with respect to additional income taxes asserted and assessed against Jefferson for the years 1958 and 1959. The amendments were timely filed and served upon Jefferson. Jefferson, by replies to the amended answers, and the counterclaims therein set forth, which replies were timely filed and served upon the defendant, denied liability for said adjustments to its income tax liabilities, and for the deficiency assessments made by the defendant and referred to in its counterclaims, to the extent and for the reasons set forth in its replies.

II

The Applicable Rate of Tax

12. Both Jefferson and Pilot are life insurance companies subject to the tax imposed under § 802 of the Code.

13. The form 1120 L, corporate income tax return provided by the Internal Revenue Service for use by life insurance companies subject to the tax imposed by § 802 of the Code for 1958 and 1959, specified a tax of 30 percent on amounts not over $25,000.00 and 52 percent on amounts in excess of $25,000.00. Said form further specified, in the event a consolidated return was filed, a tax of 32 percent on amounts not over $25,000.00 and 54 percent on amounts in excess of $25,000.00. Jefferson computed and paid tax at the latter rates on its consolidated returns for 1958 and 1959.

14. The form 1120, corporate income tax return for corporations subject to the tax imposed under § 15 or § 204 of the Internal Revenue Code of 1939, with respect to such returns for each of the years 1942 through 1953, contained the question: "Is this a consolidated return?" Said form further contained, in the computation of the tax for such corporations, a parenthetical reference to a higher tax rate in the case of consolidated returns.

15. The form 1120 L, corporate income tax return for life insurance companies subject to the tax imposed under § 201 of the Internal Revenue Code of 1939, with respect to returns for each of the years 1942 through 1953, contained the question: "Is this a consolidated return?" However, said form contained no reference, in the computation of tax for life insurance companies, to a higher tax rate, or to an additional tax in the case of consolidated returns.

16. The form 1120, corporation income tax return for corporations subject to the tax imposed under § 11(c) or

§ 831 of the Internal Revenue Code of 1954, with respect to returns for each of the years 1954 through 1957, contained the question: "Is this a consolidated return?" Said form further contained, in the computation of the tax for such corporations, a parenthetical reference to a higher tax rate in the case of consolidated returns.

17. The form 1120 L, corporate income tax return for life insurance companies subject to the tax imposed under § 802 of the Internal Revenue Code of 1954, with respect to the returns for each of the years 1954 through 1957, contained the question: "Is this a consolidated return?" However, said form contained no reference, in the computation of the tax for life insurance companies, to a higher rate or an additional tax in the case of consolidated returns.

18. The form 1120, corporate income tax return for corporations subject to the tax imposed under § 11(c) or § 831 of the Internal Revenue Code of 1954, with respect to returns for the years 1958 and 1959, in the computation of tax for such corporations, contains a parenthetical reference to a higher tax rate in the case of consolidated returns. These returns also contain the question: "Is this a consolidated return?"

19. The form 1120 L, corporate income tax return for life insurance companies subject to the tax imposed under § 802 of the Internal Revenue Code of 1954, with respect to returns for the years 1958 and 1959, in the computation of the tax for such life insurance companies, contains a parenthetical reference to a higher tax rate in the case of a consolidated return. This form also contains the question: "Is this a consolidated return?"

III

Determination of Consolidated Taxable Income

20. Jefferson acquired 100 percent of the outstanding stock of Pilot by purchase prior to 1958, and at a time

when Pilot's net worth was equal to the purchase price paid by Jefferson for said stock.

21. In each of the years 1958 and 1959, Pilot paid dividends in the amount of $1,250,000.00 to Jefferson out of current earnings and profits of the year.

22. Pilot was solvent at all times during 1958 and 1959.

23. For the years 1958 and 1959, Jefferson and Pilot elected to file consolidated Federal income tax returns. In both returns, Pilot and Jefferson were treated as parts of a single entity. The computations of taxable investment income (Phase I) and gain from operations (Phase II), made in determining the income tax of life insurance companies, were made by consolidating the figures for the two companies on an item-by-item basis, eliminating from all computations the intercompany dividends and the intercompany investments.

24. The dividends distributed by Pilot to Jefferson during 1958 and 1959 did not reduce Pilot's assets to a point where they were inadequate to satisfy its liabilities to creditors and the requirements for reserves for its policies required under the law.

25. At all times during 1958 and 1959, the assets of Jefferson were adequate to satisfy its liabilities to creditors and the requirements for reserves for its policies without taking into account either Jefferson's investment in the stock of Pilot or the amount received as dividends from Pilot.

26. In 1958 and 1959, Jefferson, for purposes of Phase I (consolidated taxable investment income), computed a consolidated investment yield figure and a consolidated policy and other contract liability requirements figure. The investment yield of the two separate companies were combined and the intercompany dividend paid by Pilot to Jefferson was entirely eliminated to arrive at a con-

solidated investment yield. In determining a consolidated policy and other contract liability requirements, the assets of the two separate companies were combined with the investment in the stock of Pilot held by Jefferson eliminated to arrive at consolidated assets. A current earnings rate was obtained by dividing the consolidated investment yield by the consolidated assets. Earnings rates for the preceding years were determined in the same manner, and an adjusted reserves rate was computed from these earnings rates. The life insurance reserves of the two companies were combined to arrive at consolidated life insurance reserves. The adjusted life insurance reserves were computed by using the consolidated life insurance reserves, the average rate of interest assumed on the consolidated life insurance reserves, and the adjusted reserves rate determined by using consolidated investment yields and consolidated assets. The consolidated policy and other contract liability requirements were determined by multiplying the adjusted life insurance reserves by the adjusted reserves rate and by combining the interest paid by the two companies. Further, in 1959, the applicable portions of pension plan reserves of the two companies were combined to arrive at consolidated pension reserves, and the consolidated pension reserves were multiplied by the current earnings rate. A policyholders' share percentage was determined on the basis of the consolidated policy and other contract liability requirements and consolidated investment yield. This policyholders' share percentage was applied to the items of consolidated investment yield to determine a policyholders' share of consolidated investment yield and a company's share of consolidated investment yield. Only one $25,000.00 small business deduction was taken into account in each of the years 1958 and 1959.

27. For 1958 and 1959, Jefferson, for purposes of Phase II (consolidated gain from operations) computed a consolidated required interest figure and a consolidated in-

vestment yield figure. The investment yields of the two separate companies were combined and the intercompany dividend paid by Pilot to Jefferson was entirely eliminated to arrive at a consolidated investment yield. In determining a consolidated required interest figure, the life insurance reserves of the two companies were combined and required interest was computed on the combined life insurance reserves of the two companies. A percentage of investment yield set aside for policyholders was determined on the basis of the consolidated required interest and the consolidated investment yield. This percentage was applied to the items of consolidated investment yield to determine a share of consolidated investment yield set aside for policyholders and a company's share of consolidated investment yield. In computing the increase in reserves which is required by § 810(b) and allowed as a deduction by § 809(b)(2) of the Code, Jefferson, for 1958 and 1959, reduced the consolidated increase in reserves by the share of the consolidated investment yield set aside for policyholders under § 809(a)(1) of the Code. Only one $25,000.00 small business deduction was taken into account in each of the years 1958 and 1959.

28. Jefferson's method of consolidation used on its tax returns results in a consolidated policyholders' share for purposes of Phase I which will not be equal to the sum of separate policyholders' shares of Jefferson and Pilot. For example, based upon the figures contained in the Revenue Agent's report for 1958, a consolidated policyholders' share for Phase I computed in accordance with Jefferson's method of computation would be $20,335,417.00, and separate policyholders' share of Jefferson and Pilot, computed in accordance with the defendant's method, would be $15,665,587.00 for Jefferson and $4,671,952.00 for Pilot, or a total of $20,337,539.00, or $2,122.00 more than the policyholders' share under the method employed by Jeffer-

son. Based upon the figures contained in the Revenue Agent's report for 1959, a consolidated policyholders' share for Phase I computed in accordance with Jefferson's method of computation would be $22,056,815.00, and separate policyholders' shares of Jefferson and Pilot, computed in accordance with the defendant's method, would be $16,888,052.00 for Jefferson and $5,156,668.00 for Pilot, or a total of $22,044,720.00, or $12,095.00 less than the policyholders' share under the method employed by Jefferson.

29. Upon audit of Jefferson's consolidated income tax returns for 1958 and 1959, the Commissioner of Internal Revenue disapproved Jefferson's method of computing its taxable income. The method employed by the Commissioner in the Revenue Agent's report was as follows:

(a) The Commissioner in determining the taxable investment income of Jefferson for purposes of Phase I investment income, first and prior to any consolidation, separately computed each company's policy and other contract liability requirements. This amount for each company was arrived at in accordance with the provisions covering the determination of policy and other contract liability requirements of separate companies. For purposes of these separate computations, the dividends received by Jefferson from Pilot were included in the gross investment yield of Jefferson and the value of the Pilot stock held by Jefferson was included as an asset of Jefferson. The policyholders' share exclusion for Jefferson was calculated by dividing its investment yield by assets and applying the earnings rates so obtained to its adjusted reserves. The policyholders' share of Pilot was obtained in the same manner. The ratio of the policy and other contract liability requirements of each company to its gross investment yield was then applied to each and every item of investment income to determine the policyholders' share of each item of its investment income.

(b) When the time came (Schedule C of the tax returns) to allocate (on the basis of the ratio as determined in (a) above) each and every item of investment yield between the company and the policyholders, the dividend received portion of consolidated investment yield was first reduced by 100 percent of the Pilot dividends prior to allocation. Having thereby eliminated 100 percent of the Pilot dividends in the course of consolidation, that portion of the policyholders' exclusion of dividends received was reduced by the amount attributable to the Pilot dividends.

(c) Similarly, in determining taxable income for purposes of Phase II, gains from operations, separate figures for gross investment income and investment yield were computed for each company. In the computation of the exclusion of the share of investment yield set aside for policyholders of Jefferson under § 809(a) of the Code, the Pilot dividends and the value of Pilot stock were included. Each company's separately determined "required interest" was divided by its investment yield to obtain each company's policyholder exclusion percentage. The allocation of each item of investment yield and the treatment of the Pilot dividend was handled in the same manner as described in (b) above.

30. At the trial of these actions, the defendant presented another method of computing consolidated taxable investment income. This method also utilized separately computed policy and other contract liability requirements and investment yields determined without eliminating either the intercompany dividends paid by Pilot to Jefferson or the investment in the stock of Pilot held by Jefferson. A policyholders' share percentage was determined for each company on the basis of the separately determined policy and other contract liability requirements and investment yields. This policyholders' share percentage for each company was applied to the individual items of

investment yield for each company to determine a policyholders' share to be excluded for that company. The intercompany dividends paid by Pilot to Jefferson were not eliminated from the separately determined investment yield of Jefferson. Consolidated investment yield was determined by combining the individual items of investment yields of the two companies and without excluding the intercompany dividends paid by Pilot to Jefferson. The policyholders' share of consolidated investment yield was determined by combining the separately determined policyholders' shares of the investment yield. This policyholders' share of consolidated investment yield was subtracted from the consolidated investment yield that included the intercompany dividends to arrive at a company's share of consolidated investment yield. This company's share was then reduced by eliminating a portion of the intercompany dividends equal to the percentage which the separately determined Jefferson company's share was of the separately determined Jefferson investment yield. One $25,000.00 small business deduction was taken into account in each of the years 1958 and 1959. The consolidated taxable investment income computed under this method was the same as consolidated taxable investment income computed in the Revenue Agent's Report.

31. At the trial of these actions, the Government also presented another method of computation of consolidated gain from operations. This method likewise utilized separately determined required interests and investment yields. The separate investment yields were determined as if each company was filing a separate return without excluding the intercompany dividends paid by Pilot to Jefferson. A percentage for share of items, investment yield set aside for policyholders was determined for each company on the basis of the separately determined required interests and invest-

to the individual items of investment yield for each company to determine a share set aside for policyholders to be excluded for that company. The intercompany dividends paid by Pilot to Jefferson were not eliminated from the separately determined investment yield of Jefferson. Consolidated investment yield was determined by combining the individual items of investment yield of the two companies and without eliminating the intercompany dividends paid by Pilot to Jefferson. The share of consolidated investment yield set aside for policyholders was determined by combining the individual items of share of investment yield of the separate companies set aside for policyholders. This share of consolidated investment yield set aside for policyholders was subtracted from the consolidated investment yield that included the intercompany dividends to arrive at a company's share of consolidated investment yield. This company's share was then reduced by eliminating a portion of the intercompany dividends equal to the percentage which the separately determined Jefferson company's share was of the separately determined investment yield. This portion of the intercompany dividends was the only portion that was eliminated from consolidated gain from operation. Only one $25,000.00 small business deduction was taken into account in each of the years 1958 and 1959.

32. In both 1958 and 1959, Jefferson's gain from operations exceeded its taxable investment income, so that there was consolidated taxable income under both Phase I and Phase II.

33. The duties of the officers of Pilot are separate and distinct from the duties of the officers of Jefferson.

34. The officers of Jefferson do not exercise day-to-day operational control over Pilot's officers.

35. Jefferson sells only life insurance, while Pilot is known as a multiple line company in that it sells accident and health policies, both to individuals and to groups, in addition to selling life insurance.

36. The agents of Jefferson and Pilot work out of different agency offices.

37. No joint advertising is conducted which couples Jefferson and Pilot.

38. Under generally accepted accounting principles, a consolidated financial statement would not normally be prepared for Jefferson and Pilot. However, a consolidated income tax return is a form of financial statement that might be used for special purposes.

39. Jefferson does not prepare for distribution or publication any consolidated financial statements, and annual reports for stockholders for Jefferson and Pilot are separately prepared.

40. Generally accepted accounting principles of consolidation require the elimination of intercompany dividends in the preparation of consolidated statements of income, and such principles apply in the case of consolidated statements of life insurance companies as well as in the case of consolidated statements of ordinary business corporations.

41. Generally accepted accounting principles of consolidation further require, in the preparation of consolidated financial statements, the elimination of intercompany investments in the stock of a subsidiary, and such principles apply in the case of consolidated statements of life insurance companies as well as in the case of consolidated statements of ordinary business corporations.

42. The Commissioner does not dispute the right of Jefferson to file a consolidated tax return, but maintains that prior to consolidation separate computations must be made for each company to determine its policyholders' share exclusions.

43. A substantial portion of the investment income earned by a life insurance company is necessary to provide assets

which, together with premium collections, will permit the company to meet its future obligations to policyholders.

44. In a typical life insurance company, approximately 80 to 85 percent of the liabilities represent liabilities to policyholders.

45. Approximately 75 to 80 percent of the assets of Jefferson and Pilot in 1958 represented obligations to policyholders.

46. From an accounting standpoint, the reserves required of an insurance company to meet obligations to its policyholders are considered as liabilities.

47. Jefferson reflects its policyholder reserves as liabilities, both for the purpose of its Annual Statement and its Report to Stockholders.

48. Contracts of insurance to individual policyholders run only to the issuing company, just as the liabilities of any individual company in an affiliated group run only to the individual company.

49. Since insurance companies have an obligation to properly protect their policyholders, sound accounting principles require the separate computation of the amounts which stand to protect the policyholders' share of each company before these interests may be consolidated.

50. The overriding concern of the State Insurance Commissioners is the protection of the policyholders, and the maintenance of sufficient reserves for the policyholders by individual companies. In examining Jefferson, no distinction is made by the Insurance Commissioner between the dividends Jefferson receives from Pilot as opposed to other sources of income. All such dividends are considered as available to meet Jefferson policyholder obligations. Further, in determining the adequacy of Jefferson's reserves, the Pilot shares of stock are not excluded.

51. The Annual Statements of Jefferson filed with the Insurance Commissioner reflect the Pilot dividends and the Pilot stock held by Jefferson.

52. As of December 31, 1959, the carrying value of Pilot stock was increased by Jefferson in the amount of $7,500,000.00. An amount equal to this increase, plus additional funds, was used to increase the reserves for Jefferson's policyholders for all years subsequent to December 31, 1959.

53. Under generally accepted accounting principles, the liabilities of an affiliated group of life insurance companies as a result of their obligation to policyholders, are computed and shown on a consolidated financial statement on the basis of the benefits to be paid under the policy contracts, the premiums collected and anticipated (net of underwriting expenses), and the assumptions made as to rate of return on investments and mortality among policyholders. Such liabilities, and the changes in such liabilities from year to year, are determined without regard to either the source of the amount of investment income received or earned by the companies during the year. Such liabilities are consolidated by adding together such liabilities for the separate insurance companies in the affiliated group.

54. The terms "policyholders' share of investment yield," "share of investment yield set aside for policyholders," and "policyholders' share," which are frequently used to describe figures used in the computations under the Life Insurance Income Tax Act of 1959, are different from the reserves which are required to be maintained by law for the protection of policyholders, and are different from increases in said reserves. Said quoted terms refer only to income tax concepts used in measuring the amount of certain income exclusions that are made in the computation of Federal income tax.

55. Since the dividends paid by Pilot to Jefferson in 1958 and 1959 were paid from current earnings and profits, and Pilot had taxable investment income included in consolidated taxable investment income and investment yield included in consolidated gain from operations in both 1958 and 1959 in amounts in excess of the amount of the intercompany dividends, use of any portion of the intercompany dividends in such years to satisfy a portion of a policy or other contract liability requirements figure computed under Phase I for Jefferson, or to satisfy a portion of a required interest figure computed under Phase II for Jefferson, would satisfy such portions from income of Pilot that was subject to income tax in the same year.

56. Neither the method of computation used by the defendant in the revenue agent's reports for 1958 and 1959, nor the method of computation used by the defendant in its illustrative exhibits presented at the trial of the cases, eliminated completely the intercompany dividends for purposes of either the Phase I or Phase II computations. Such intercompany dividends were not eliminated under such methods to the extent that they were used to satisfy policy and other contract liability requirements for purposes of Phase I, or to satisfy the required interest for purposes of Phase II.

57. Under generally accepted accounting principles of consolidation, in the case of a consolidated financial statement of two life insurance companies for a year in which an intercompany dividend is paid, no reduction is made in the sum of the net increases in policy reserves of the two companies by reason of elimination of the intercompany dividend.

58. The method of consolidation used by Jefferson for purposes of Phase I and Phase II computations on the consolidated returns for 1958 and 1959 reflected consolidated taxable investment income and consolidated gain from operations, and such method reached the same results as

would have been reached if Jefferson and Pilot had merged prior to 1958 and had operated in 1958 and 1959 as a single life insurance company.

IV

Branch Office Managers Supplemental Retirement Plan

59. On or about January 1, 1956, Jefferson, as an employer, established a Branch Office Managers Supplemental Plan, which is in evidence as Plaintiff's Exhibit 8. This Plan was in effect in the taxable years 1958 and 1959.

60. A purpose of the Branch Officers Supplemental Retirement Plan was to provide supplemental pension benefits to the managers to augment the benefits they could receive as a member of the Pension Plan for agents.

61. The Plan covered Jefferson's branch office managers who were in charge of regional sales offices throughout the country.

62. Each manager was automatically included in the Plan, and no consent was necessary.

63. Upon the adoption of the Plan, all branch officers were notified by letter of the provisions and application of the Plan, and persons subsequently becoming branch office managers were so notified when appointed as branch office managers.

64. Under the Plan, Jefferson was to make contributions to the Plan based upon the employee's salary. However, such contributions were not to be set apart or treated as separate funds, but were to constitute a part of the general corporate funds of the Company.

65. With respect to Jefferson's contributions, Section 5 of the Plan provided as follows:

> "5. *Company's Contribution.* Each year the Company will contribute to the Plan an amount equal to 4% of

the Manager's compensation for each Manager who has not attained age fifty-five (55) during such year, and an amount equal to 5% of such compensation for each Manager who has attained age fifty-five or over during such year."

66. With respect to eligibility, Section 3 of the Plan provided as follows:

"3. *Eligibility for Membership.* All Branch Office Managers of the Jefferson Standard Life Insurance Company (hereinafter sometimes referred to as *Manager*) shall be eligible for membership in this Retirement Plan."

67. With respect to change or termination, Section 11 of the Plan provided as follows:

"11. *Change or Termination of Plan.*

"(a) The Company hopes and expects to continue the Retirement Plan indefinitely but must necessarily reserve the right to change or discontinue it at any time, provided, however, no such change or discontinuance shall affect the right of any Manager to receive, upon attaining age sixty-five and if otherwise eligible hereunder, any benefits accrued to his account under this Plan prior to the effective date of such change or termination.

"(b) If at any time during the first ten years following the effective date of the Plan, the Plan shall be terminated and the full current cost of the Plan shall not have been paid, thereafter the Company's contributions which may be used for the benefit of any one of the twenty-five highest paid Managers on the effective date of this Plan whose benefits upon retirement exceed Fifteen Hundred ($1,500) Dollars per year, shall not exceed the greater of either (1) $20,000 or (2) an amount computed by multiplying the smaller of (i)

$10,000 or (ii) 20% of such Manager's compensation during the last five years of service, by the number of years since the effective date of the Plan. Any excess reserves arising upon the application of the foregoing provision shall be used and applied for the benefit of other participating Managers and retired participating Managers on the basis of the liabilities under the Plan on account of each of them."

68. With respect to annuity benefits, Section 6 of the Plan provided as follows:

"6. *Annuity Benefits.* The amount contributed by the Company each year will be used by it to provide a deferred life annuity for the Manager, with the first payment from said annuity to be made on the first day of the second month following the Manager's sixty-fifth birthday. The monthly annuity provided for by this paragraph shall be calculated on the basis of the net 1937 Male Standard Annuity Table with 3% interest."

69. Section 12(a) of the Plan provided as follows:

"(a) Membership in the Plan shall not affect the right of the Company to terminate any Branch Office Manager's contract. The Company's authority and control over its Managers and the terms of their employment shall be as absolute and unconditional as though this Retirement Plan had never been adopted, and no provision hereof, or action taken hereunder, shall be construed as giving to any member of the Plan the right to permanent employment with the Company."

70. With respect to forfeiture of benefits, Section 8 of the Plan provided as follows:

"8. *Forfeiture of Benefits.* If a Branch Office Manager's service as Branch Office Manager is discontinued

prior to his sixty-fifth birthday, but if he remains a member of the Jefferson Standard Life Insurance Company Agents' Retirement Plan in accordance with its terms, the amount of annuity earned by such Manager as provided hereunder up to the date of such discontinuances of service as Branch Office Manager shall be paid to him beginning at age sixty-five. If at any time while under age sixty-five the Branch Office Manager ceases for any reason to be a member of the Jefferson Standard Life Insurance Company Agents' Retirement Plan, or if after retirement or termination of employment the Manager shall die or shall become an employee of another life insurance company or shall act or contract to act as life insurance underwriter, agent or sales representative for any other company engaged in the business or selling life insurance, then all unpaid annuity payments and benefits provided herein shall be forfeited."

71. Regardless of the number of years an employee belonged to the Plan, and the amounts contributed by Jefferson to the Plan, the employee had no right to any cash value in the Plan.

72. No actual annuity contracts of any sort were issued to Branch Office Managers upon their inclusion in the Plan, and their annuity contracts consisted of the adoption of the Plan by Jefferson, the notification to Branch Office Managers of their rights under the Plan, and annual reports made to them by Jefferson.

73. Jefferson, as a part of its insurance business, issued life annuity contracts.

74. Ordinarily, once a life annuity is issued, Jefferson cannot, of its own accord, cancel the benefits.

75. Ordinarily, under life annuities issued by Jefferson, a policyholder has a right to any guaranteed cash surrender in the contract.

76. With respect to reserves, Section 10(b) of the Plan provided as follows:

> "(b) The Company shall maintain a reserve for its obligation under all benefits guaranteed under this Plan. Each year the Pension Committee shall determine the amount of the Company's contributions required to meet the reserve under the Plan, and upon approval by the Company contributions shall be made accordingly.
>
> "All contributions made by the Company shall be added to such reserve, which reserve shall not thereafter be decreased, except by payment of benefits under the Plan, until all payments required under the Plan have been made."

77. Jefferson established a reserve for the Branch Office Managers Supplemental Retirement Plan computed on the basis of the 1937 Standard Annuity Mortality Table, with interest at the rate of three percent. This table is one of the tables specified in Section 58-201.1 of the General Statutes of North Carolina, and is one of the bases for annuity reserves approved by the Commissioner of Insurance of North Carolina. Jefferson used this table in computing reserves for annuity contracts issued by it, and it is widely used throughout the United States by other companies in computing reserves for annuity contracts.

78. The amount of the reserve set aside for the Branch Office Managers Supplemental Retirement Plan at the beginning of the year 1958 was $150,488.00, the amount of the reserve at the end of the year 1958 was $232,516.00, and the amount of the reserve at the end of 1959 was $309,752.00. These reserves were computed on recognized mortality tables and assumed rates of interest, and were included in Jefferson's regular reserve funds.

79. Jefferson maintained a separate valuation record sheet for each member of the Plan, showing information needed in connection with the administration of the Plan

with respect to that member. The separate valuation record sheet also contained a determination of Jefferson's reserve liability with respect to the annuity provided under the Plan for that member.

80. Jefferson submitted the Plan to the Internal Revenue Service for a ruling as to whether it qualified under Section 401 of the Code. The Internal Revenue Service ruled that the Plan did not meet the requirements of Section 401 of the Code, citing the fact that the Plan discriminated in favor of the managerial category. This fact did not in any way affect Jefferson's determination as to the amount of the reserve under the Plan.

81. During 1958 and 1959 there were approximately 65 to 70 managers covered under the Plan. The entire cost of the Plan was contributed by Jefferson.

82. Over a dozen of the branch office managers covered by the Plan in 1958 and 1959 were later retired and each of them received benefits under the Plan. Some of the branch office managers who had been covered under the Plan prior to 1958 and 1959 retired in those years and received benefits under the Plan.

83. One of the purposes for which the Insurance Commissioner examined Jefferson's reserves was to determine if they were inadequate or excessive, and on the proper tables. The Insurance Commissioner requires a reserve if there is any doubt whatever that the company may be liable.

84. The Insurance Commissioner would reduce, or recommend that a reserve be reduced or excluded, when such reserves were twice included as liabilities.

85. For purposes of the annual statements filed with the State Insurance Commissioner and the Federal income tax returns filed for the years pertinent herein, the contribution of Jefferson to the Plan was carried as an income item, the actual payments made to retired managers during the year were shown as annuity benefit payments; the

amount of the insurance in reserve was shown as a deduction for increase in reserves in the summary of operations; and the cost of the Plan to Jefferson was shown as a general business expense.

86. If a branch office manager ceased to be a manager, but continued as an agent and member of the Agents' Pension Plan, all credits set aside for his benefit under the Branch Office Managers Plan remained to his credit and were payable to him, beginning at age 65.

87. The Commissioner treated the Plan as a deferred compensation Plan, allowing in full all deductions based on actual benefits paid to employees, eliminating the contributions both as a deduction and as an income item, and eliminating amounts designated as funding for the Plan from life insurance reserves, for purpose of computing policy and other contract liability requirements, required interest and increases in life reserves.

V

Computations for Annual Statement

88. The National Association of Insurance Commissioners (hereinafter referred to as N.A.I.C.), is a national organization composed of the officials of the various states who are charged with the supervision of insurance affairs. It was organized in 1871. Soon after its organization, the N.A.I.C. adopted a uniform Annual Statement blank, and the Annual Statement forms that have been filed by insurance companies since that time have been forms approved by the N.A.I.C.

89. Jefferson and Pilot were each required by the laws of the State of North Carolina and of the other states in which they did business, to complete and file the Annual Statement form approved by the N.A.I.C.

90. Both the Annual Statement form and the instructions for its completion were prepared and approved by the N.A.I.C.

91. State Insurance Departments require each company to prepare its own Annual Statement separately and submit it to the Insurance Department. It is required to be filed on an individual basis because it is essentially for the purposes of supervision by the supervising regulatory authority. The primary concern of the regulatory authorities is the protection of the policyholders.

92. Jefferson and Pilot were required to compile the Annual Statement form, and to comply with it and the instructions regarding its completion, and each did so with respect to its Annual Statements for the years 1958 and 1959.

93. Both Jefferson and Pilot were examined in 1961 for the three-year period 1958 through 1960, pursuant to the procedures of the N.A.I.C., by a team of examiners from the insurance departments of various states, including North Carolina. In no respect was the treatment on the Annual Statements for 1958 and 1959 of matters relevant to issues in these cases disapproved or changed by the examination reports resulting from the 1961 examinations.

94. The N.A.I.C. maintains a committee on forms, the purpose of which is to study the form with a view to appropriate revisions from time to time.

VI.

Unearned Investment Income

95. Upon audit of Jefferson's income tax returns for 1958 and 1959, the Commissioner required that certain amounts of interest and rent actually received by Jefferson, but as yet unearned, should be included in investment income.

96. The Commissioner also required that interest which was not collected when due under the terms of policy loan contracts, but added by Jefferson to the principal of the loan, be included in investment income.

97. The amounts involved herein consist of the following items:

Jefferson Standard Life Insurance Company

Description	1957	1958	1959
a. Rents received for rental of premises in years subsequent to year of receipt	$20,450	$25,713	$24,536
b. Interest received on bonds, mortgage loans, and collateral notes for use of money in years subsequent to year of receipt	$146,835	$149,537	$181,821
c. Interest received on premium notes, policy loans, and liens and interest added to policy loan accounts in advance of receipt for use of money in subsequent years	$725,459	$780,360	$840,793

Pilot Life Insurance Company

Description	1957	1958	1959
a. Interest received on bonds, mortgage loans, and collateral notes for use of money in years subsequent to year of receipt	$47,109	$48,529	$52,078
b. Interest received on premium notes, policy loans, and liens and interest added to policy loan accounts in advance of receipt for use of money in subsequent years	$ 308	$ 151	$ 126

98. The interest on policy loans arises when an insured borrows money from the company in connection with a specific life insurance policy and assigns to the company all profits and proceeds then due, or which may thereafter become due, as the sole security for the repayment of the loan and the interest thereon.

99. The advance receipt of interest arose because of the practice of Jefferson and Pilot of collecting a full year's interest on policy loan accounts on their anniversary dates, or by reason of the fact that interest in default was added to the principal of a borrower's loan pursuant to the terms of his contract.

100. The net amount included in gross investment income for the year 1958 by reason of this item was $64,129.00 (consisting of $62,866.00 as to Jefferson, and $1,263.00 as to Pilot) and for the year 1959 was $95,064.00 (consisting of $91,540.00 as to Jefferson, and $3,524.00 as to Pilot).

101. Plaintiff's Exhibit 10 illustrates the manner in which unearned policy loan interest was handled on the records of Jefferson in making the computations necessary for the annual statement, both with respect to interest paid in cash on the anniversary date and with respect to interest unpaid but added to the policyholders' loan account on the anniversary date. Based on a situation where the policy anniversary date was July 1, and a policy loan was made on July 1, 1957, for $1,000.00, and the interest was $56.60, Jefferson deducted the interest of $56.60 in advance from the loan, paying to the policyholder the balance of $943.40. At the end of the year (December 31, 1957), Jefferson made an adjustment on its records reflecting one-half of $56.60 as earned in 1957, and set up the balance as a deferred item to be taken into income in 1958. If the policy loan interest of the same amount was in default, and added on the outstanding loan to the policy loan account, then, as of the end of the year, one-half of the $56.60 was considered

as interest earned in that year and the balance was deferred until 1958.

102. The typical policy loan certificates under which interest payments herein referred to arise, provides that "interest shall be payable annually in advance," and "any interest not paid when due shall be added to the principal of the loan and bear interest at the same rate."

103. Both in the case of interest paid in advance by a borrower and interest charged to a policy loan account in advance of receipt, in the event the loan balance was reduced or paid in full during the period to which the interest paid in advance or the unearned interest related, the resulting excess amount of interest was paid to, or credited to the account of, the borrower, or, if the borrower was a deceased policyholder, to the beneficiary under the policy. However, no evidence was presented by Jefferson that it attempted to estimate in advance the refunds to be made, and no evidence was presented of the actual amounts refunded.

104. The record does not disclose the specific reason giving rise to the advance receipt of rents. Presumably, the greater portion is attributable to receipt of a full year's rental in advance, with a portion of the amount attributable to the subsequent calendar year.

105. For the years 1957, 1958, and 1959, Jefferson and Pilot prepared and filed with the State Insurance Commissioner annual statements on forms approved by N.A.I.C. On these annual statements, the portions of rent received in a year for rental of premises during such year were treated as earned income, and the portions of interest received during the year for the use of money during such year, and the portion of interest added to policy loan accounts for the use of money during such year, were treated as earned income, and the remainders of the amounts of rents or interest received during the year, or added to

policy loan accounts during the year, exclusive of amounts of earned income of prior years, were deferred as unearned income and reported as income in the subsequent year when earned. These items were required to be computed and reported on such Annual Statements in this manner.

106. Jefferson treated unearned investment income on its 1958 and 1959 tax returns in the same manner as Jefferson and Pilot treated such items on the Annual Statements approved by N.A.I.C.

107. The issue herein is simply whether the amounts of rent and interest actually received or credited must be included in investment income in the year received or credited, or may they be deferred for tax purposes.

VII

Charitable Contributions

108. Jefferson paid charitable contributions amounting to $59,817.59 in 1958 and $68,443.66 in 1959. Pilot paid charitable contributions amounting to $16,183.34 in 1958 and $16,991.67 in 1959.

109. Jefferson allocated a portion of its contributions to investment expense by applying to the total contributions the ratio of the number of employees in investment functions to total employees. Pilot allocated a portion of its contributions to investment expense by applying to total contributions the ratio of salaries of employees engaged in investment functions to total salaries. These allocations have been accepted for many years by the State insurance departments for purposes of the Annual Statements.

110. A portion of charitable contributions was claimed for Federal tax purposes as an underwriting expense, and a portion as an investment expense. The defendant disallowed only the deduction for charitable contributions as

an investment expense, but would permit their deduction in full in the computation of underwriting income.

111. The charitable nature or amount of the contributions is not in issue, nor is the method of allocation used for Annual Statement purposes in dispute.

112. Charitable contributions allocated to investment expense by Jefferson amounted to $20,936.00 for 1958 and $23,955.00 for 1959. Charitable contributions allocated to investment expense by Pilot amounted to $3,275.00 for 1958 and $3,571.00 for 1959.

113. Life insurance companies, including Jefferson and Pilot, were required for purposes of the Annual Statement approved by the N.A.I.C., to allocate charitable contributions between investment expense and underwriting expense on a reasonable basis.

114. Of the total amount of charitable contributions paid by Jefferson in 1958, over 93 per cent was paid to organizations in North Carolina and 49 per cent was paid to organizations in the Greensboro area. In 1959, over 95 per cent was paid to organizations in North Carolina and 54 per cent was paid to organizations in the Greensboro area. During 1958 and 1959, Jefferson employed approximately 550 people in Greensboro.

115. Of the total amount of charitable contributions paid by Pilot in 1958, over 94 per cent was paid to organizations in North Carolina, and over 63 per cent was paid to organizations in the Greensboro-High Point area. In 1959, over 93 per cent was paid to organizations in North Carolina and over 67 per cent was paid to organizations in the Greensboro-High Point area. During 1958 and 1959, Pilot employed approximately 500 people in the Greensboro area.

116. The computations of the portion of charitable contributions treated as investment expense in 1958 and 1959

by Jefferson and Pilot were made in a manner consistent with the manner required for the purposes of the Annual Statement approved by N.A.I.C.

VIII

Increase in Loading on Deferred and Uncollected Premiums

117. It is a common practice in the life insurance industry to permit policyholders to pay premiums in semiannual, quarterly, or monthly installments. However, additional charge or interest-type factor is added to the amount of the annual premium when an installment method of paying the premium is elected. Jefferson and Pilot follow this practice.

118. "Deferred premiums" are the fractions of annual premiums, on policies with premiums payable in installments, that become due after December 31 of the calendar year and before the next policy anniversary date.

119. "Uncollected premiums" are annual or installment premiums that, as of December 31 of a calendar year, have become due but which have not been paid.

120. On its Federal income tax returns for 1958 and 1959, in computing gain from operations under Phase II, the taxpayer included in income the gross amount of all premiums, including the gross amount of deferred and uncollected life insurance premiums, and gross amount of accident and health insurance premiums due and unpaid. From these amounts, however, the taxpayer deducted what is referred to as "increase in loading on deferred and uncollected premiums." It is the correctness of this latter deduction which is at issue herein.

121. Under the requirements of State insurance laws, the holder of a life insurance policy has a 31-day grace period after a premium on his life insurance policy has become due, whether the premium is an annual premium

or an installment premium, within which to pay the premium and thus maintain his rights under the policy.

122. The contract premium on an insurance policy is considered to be made up of two parts, a net valuation portion and a loading portion.

123. The gross contractual premium, i.e., the amount actually charged the insured, results from an independent judgment of the company of the amount required to provide all benefits under the policy, to cover all expenses, and to provide a profit.

124. Regardless of the company's own estimates, State statutes call for reserves to be maintained based upon a "net valuation premium," i.e., an amount based upon a mortality table and interest rates contained in the statute for the particular policy and its benefits.

125. The difference between the statutory valuation net premium and the gross contractual premium calculated by the company is referred to as the "loading."

126. "Loading" is the excess of the gross premium provided in a life insurance policy contract over the net valuation premium used in determining the reserves for the policy. A purpose of loading is to pay for expenses incurred in writing and caring for insurance policies and annuity contracts, and as a margin for possible contingencies.

127. The loading element of a premium may thus be zero if and when the net valuation premium, i.e., the amount required under State law to be put into reserves for the policy, equals or exceeds the gross contract premium as computed by the company.

128. The reserves attributable to policies having deferred and uncollected premiums are computed by Jefferson on the assumption that the entire deferred or uncollected premiums had been paid. Thus, Jefferson credits reserves for its full year's liability under the policy.

129. The Annual Statements of Jefferson and Pilot submitted to the State Commissioner of Insurance call for the deduction of all actual costs incurred in servicing the policy when such costs are incurred, and such actual costs are deducted accordingly, in addition to the deduction for increases in loading on deferred and uncollected premiums. These actual expenses are deducted as commissions, general expenses, taxes, licenses and fees, etc.

130. Jefferson received deductions in full in computing underwriting income on its Federal income tax returns for 1958 and 1959 for all such expenses paid or incurred in those taxable years.

131. The expenses incident to the writing and servicing of a policy by a life insurance company are greater the first few years of the policy. There is no necessary coincidence in the amount of the actual expenses and the amount referred to as "loading" for any particular year.

132. With respect to the deduction of loading on deferred and uncollected premiums:

(a) Such deductions in the first year of a policy would result in an additional deduction over and above the deduction for actual costs incurred with regard to the policy which are deducted in full elsewhere;

(b) In the second year of the policy, assuming its terms were not changed and the policyholder continued payments on the same deferred basis, such additional deductions would not be recovered, as the loading at the end of the first year (actually received in the second year) would be equally offset by the deduction for new loading at the end of the second year. The company in the second year would also get a full deduction for actual costs in the second year;

(c) The only point at which the additional deduction would be recovered for tax purposes would be in the last year of the policy, or in the event the terms were

changed so as to provide for no more deferred payments;

(d) In the case of a stable or growing company, such overall deductions would not be recovered for tax purposes by the Government until some indefinite time in the future.

133. Policyholders of Jefferson and Pilot had no legal obligation to pay deferred premiums or uncollected premiums on their policies, and could cancel such policies by not paying any more premiums on them.

134. Jefferson and Pilot each complied with the requirements of the Annual Statement approved by N.A.I.C. in the computations they made with respect to deferred and uncollected premiums for 1958 and 1959.

135. The same computations and the same figures were used for Jefferson and Pilot with respect to loading on deferred and uncollected premiums for purposes of the consolidated income tax returns filed for 1958 and 1959 as were used for purposes of the Annual Statements approved by the N.A.I.C. that were filed by the separate companies.

136. The consolidated increase in loading on deferred and uncollected premiums for 1958 was $81,464.00 (consisting of a decrease of $41,348.00 as to Jefferson and an increase of $122,812.00 as to Pilot).

137. The consolidated increase in loading on deferred and uncollected premiums for 1959 was $49,013.00 (consisting of a decrease of $37,748.00 as to Jefferson and an increase of $86,761.00 as to Pilot).

IX

Deferred and Uncollected Premiums as Assets; Due and Unpaid Premiums as Assets

138. Following the common practice of the life insurance industry, Jefferson and Pilot sold life insurance policies

providing for payments of premiums in installments, resulting in deferred premiums.

139. "Deferred premiums" are those fractions of annual premiums on policies with premiums payable in installments that are payable after December 31 of the calendar year and before the next policy anniversary date.

140. "Uncollected premiums" can be any type of annual, fractional or installment premiums which, as of December 31 of a calendar year, has become due but which has not yet been paid by the policyholders.

141. Jefferson's and Pilot's deferred and uncollected premiums directly resulted from the operations of the companies' insurance trade or business, but did not arise from, and were not connected with, investment operations of the companies.

142. Jefferson and Pilot include in gross premium income as of December 31, the full amount of both deferred and uncollected premiums. A deduction is then taken for the increase in loading attributable to the deferred and uncollected premiums.

143. In computing its consolidated taxable income on its Federal income tax returns for the years 1958 and 1959, Jefferson did not include as assets any amount of deferred or uncollected premiums.

144. The gross amount of deferred and uncollected premiums at issue in these cases are:

As of December 31	Jefferson	Pilot
1953	$10,400,734.00	$2,771,657.00
1954	$10,936,811.00	$2,975,484.00
1955	$11,943,423.00	$3,341,563.00
1956	$12,741,918.00	$3,890,690.00
1957	$13,434,070.00	$4,173,083.00
1958	$13,956,125.00	$4,460,172.00
1959	$14,551,990.00	$4,800,735.00

145. The amount of loading on deferred and uncollected premiums at issue in these cases are:

As of December 31	Jefferson	Pilot
1953	$2,962,549.00	$ 618,370.00
1954	$3,105,772.00	$ 646,612.00
1955	$3,341,197.00	$ 752,693.00
1956	$3,584,036.00	$ 810,975.00
1957	$3,787,173.00	$ 837,249.00
1958	$3,766,898.00	$ 921,973.00
1959	$3,735,991.00	$1,018,762.00

146. Life insurance reserves on all policies of Jefferson and Pilot were computed on the assumption that on each policy anniversary a full annual premium had been received. In calculating all such reserves, the full annual net valuation premium was used. This is a customary and usual procedure in the life insurance industry.

147. The reserves attributable to policies having deferred and uncollected premiums were likewise computed on the assumption that the entire deferred or uncollected premium had been paid.

148. Due and unpaid accident and health premiums are premiums on accident and health insurance policies that have become due, but have not been paid by December 31 of the calendar year, and that are in either a grace period provided by law or provided administratively by the insurance company, or are in a reinstatement period.

149. Pilot's due and unpaid accident and health premiums on dates pertinent to the calculation of taxpayer's assets for purposes of these cases were as follows:

As of December 31	Pilot
1953	$247,099.00
1954	$189,578.00
1955	$228,134.00
1956	$295,962.00
1957	$330,480.00
1958	$396,707.00
1959	$373,465.00

150. Pilot's due and unpaid accident and health premiums on contracts that were not guaranteed renewable on dates pertinent to the calculation of taxpayer's assets for purposes of these cases were as follows:

As of December 31	Pilot
1953	$247,099.00
1954	$189,578.00
1955	$228,134.00
1956	$295,749.00
1957	$330,073.00
1958	$396,215.00
1959	$372,957.00

151. In computing its taxable income for purposes of its 1958 and 1959 Federal income tax returns, Jefferson did not include either the whole or any portion of these premiums or assets.

152. Pilot's treatment of due and unpaid accident and health premiums on its annual statements was not disapproved by the N.A.I.C. examiners in 1961.

X

Agents' Debit Balances

153. Agents' debit balances are the result of charges to the accounts of insurance agents made against anticipated future commissions.

154. The practice of making advances to life insurance agents and charging the advances against the agents' anticipated commissions, thereby creating agents' debit balances, is widely recognized and established in the life insurance industry. This practice, however, is not unique to the insurance industry, but rather is a typical method of financing salesmen used by any commercial organization which employs a large number of salesmen.

155. The typical corporation includes such advances as either accounts receivable or prepaid commissions. In

either case, for accounting purposes, they are treated as assets. Jefferson, however, did not reflect agents' debit balances of either Jefferson or Pilot as assets for purposes of Section 805(b)(4), and the Commissioner's determination that they should have been included as assets for such purposes is the subject of this controversy.

156. Jefferson maintained accounts for each of its agents engaged in selling insurance. The principal charges to the accounts of its agents were: (a) charge-backs of commissions previously paid or credited to the agent's account, due to cancellation of the insurance for which the commission had been paid; (b) F.I.C.A. taxes Jefferson was required to withhold from the compensation of full-time life insurance agents; (c) the agents' share of premiums on major medical health insurance and disability income insurance that was obtained by Jefferson for agents as a group; and (d) fees charged agents by Jefferson by reason of the cancellation or non-delivery of insurance policies within a specified time after they were written by the agent.

157. Pilot maintained accounts for each of its general agents, and for each of its agents engaged primarily in the sale of ordinary life insurance. The principal charges to the accounts of agents of Pilot were: (a) money advanced to the agents to provide for their living expenses until their commission income was sufficient to support them, (b) fees charged agents by Pilot by reason of the cancellation or nondelivery of insurance policies within a specified time after they were written by the agent, and (c) charges for premiums on major medical health insurance for dependents of the agents.

158. Jefferson, unlike Pilot, did not make any cash advances to agents during the pertinent years.

159. During the years 1958 and 1959, Jefferson's contracts with its agents called for a 6% interest factor payable by the agents to Jefferson on the amount of the agents'

debit balances. However, neither Jefferson nor Pilot made it a practice of charging agents with interest on debit balances in their accounts.

160. In the case of both Jefferson and Pilot, when an agent terminated his connection with the company at a time when a debit balance existed in his account, commissions to which the agent subsequently became entitled were applied against the debit balances as a matter of practice; however, no attempt was made to collect any remaining debit balance in the account from a former agent.

161. When an agent leaves the employment of either company, leaving a debit balance on his account, and there are no further commissions due to that agent, the company charges the agent's uncollected balances to general insurance expenses.

162. Non-vested commissions which are received after an agent's employment is terminated are not credited to the agent's account and the agent does not receive the money. The company uses the money to offset training and other expenses in recruiting.

163. The large percentage of the debit balances of Pilot's agents represented amounts owed by agents who were still agents of Pilot at the end of the year.

164. The agents' debit balances of Jefferson and Pilot on the following respective dates were in the following respective amounts:

As of December 31	Jefferson	Pilot
1953	$1,727.00	$204,257.00
1954	3,792.00	246,920.00
1955	2,373.00	297,487.00
1956	2,571.00	322,610.00
1957	1,868.00	329,553.00
1958	1,758.00	233,092.00
1959	2,298.00	137,163.00

165. The agents had no authority to withdraw any funds from the company by their own action and charge the amounts to their accounts.

166. The Annual Statement approved by N.A.I.C. calls for the amount of agents' debit balances to be shown as a non-admitted asset. The plaintiff's books and records reflect agents' debit balances as ledger assets.

XI

Mortgage Correspondent Escrow Funds

167. In computing its taxable investment income for Federal tax purposes, Pilot did not include the amount of escrow funds held by its mortgage correspondents in assets.

168. The amounts of these escrow funds as of December 31 of the following years were:

1953	–0–
1954	–0–
1955	$57,838.00
1956	12,824.00
1957	8,914.00
1958	19,440.00
1959	12,475.00

169. The foregoing amounts were reflected on line 13 of Exhibit 13, found on page 14 of the Annual Statements submitted to the Insurance Department of North Carolina for each of the years 1955 through 1959 as "ledger assets" and as "admitted assets."

170. Pilot's treatment of the mortgage correspondents' escrow funds at issue herein as "admitted assets" for purposes of the Annual Statements was not disapproved by the N.A.I.C. examiners in 1961.

171. The mortgages giving rise to the escrow funds at issue herein were in part FHA mortgages, and others were non-FHA mortgages.

172. As to non-FHA mortgages, Pilot's loan committee generally determine whether an escrow account will be used.

173. Of the total escrow fund involved on December 31, 1955, in the amount of $57,838.00, the amount of $9,807.00 was in Puerto Rico and the amount of $48,031.00 was in banks at or near Arlington, Virginia.

174. Some of the loans made by Pilot in Puerto Rico were secured by FHA mortgages and the remainder by non-FHA mortgages. The escrow account established under the agreement with Banco Credito, a bank in San Juan, Puerto Rico (Pilot's Puerto Rican escrow agent), was used in respect to collections from both FHA and non-FHA mortgages. The categories of items that went into the escrow account were the same in respect to both FHA and non-FHA mortgages, except for the FHA premiums.

175. In the course of handling the mortgages under the agreement with Banco Credito, the escrow funds (being a portion of the periodic payments made by the mortgagors) were received by the bank and placed in trust. The remainder of the payment, consisting of interest and principal, was remitted by the servicer to Pilot once each month.

176. Pilot did not withdraw and place in its own accounts any escrow funds held in trust by the Banco Credito, and did not invest any moneys that were accumulated by the Banco Credito and held for taxes, insurance premiums, and FHA mortgage premiums, or receive any return on such amounts. The Banco Credito was not permitted to invest these escrow funds.

177. Pilot's mortgage loan service contract with the Banco Credito provided: "Either party hereto, without cause, may at its option terminate this agreement upon sixty days" written notice given by the one to the other. "Upon the termination of this agreement, the Servicer shall forthwith deliver to the lender a statement showing

all monies collected and not theretofore paid over to lender and a statement of all monies held by it as 'Escrow Funds.' The Servicer shall immediately pay over to the lender all monies so held."

178. On or about May 1, 1946, Pilot entered into a written agreement with C. C. McClaine and others, trading as "McClaine Properties," which is in evidence as Plaintiff's Exhibit 12. Operations under this agreement are pertinent with respect to the year 1955 only. This agreement provided for a servicing arrangement under which McClaine Properties would service mortgages taken by Pilot on properties in certain counties in Virginia.

179. Under the agreement, McClaine Properties was required to deposit promptly in its trust account in a bank acceptable to Pilot all sums collected for Pilot or in connection with loans made in real estate serviced under the agreement.

180. Some of the loans made pursuant to the McClaine Properties agreement were FHA loans; the remainder were not. The escrow deposit under the McClaine Properties agreement was handled in the same general way as the escrow account was handled under the agreement with Banco Credito hereinbefore referred to.

181. The agreement with McClaine Properties had a termination clause similar to the clause in the Banco Credito contract which provided that either party might, at its option and without cause, terminate the agreement, at which time all funds were to be paid to Pilot.

182. McClaine Properties did in fact establish a separate bank account in which it deposited the monies collected with respect to loans by Pilot during the year 1955.

183. During the year 1955 Pilot did not withdraw any funds deposited under the McClaine Properties agreement from the separate bank account in Virginia.

184. In the main, Pilot serviced its own mortgages without use of mortgage correspondents. The mortgage correspondents' escrow funds here in issue were included, along with the escrow funds on mortgages that Pilot serviced itself, in the liability figures of $491,642.25 and $447,012.58 as of December 31, 1958, and December 31, 1959, respectively, on line 18, page 3, of the Annual Statement, as liabilities. The same treatment obtained as of December 31, 1955, December 31, 1956, and December 31, 1957.

185. On the asset side of the Annual Statements, page 2, the amounts actually received by Pilot for the payment of taxes, insurance, etc., i.e., escrow funds, are reflected as part of Pilot's own cash and bank deposits in those instances where there is no mortgage correspondent, and as mortgage correspondent escrow funds in those instances where Pilot's contract with its customer calls for a mortgage correspondent.

186. Those escrow funds actually received by Pilot on mortgages Pilot serviced itself were treated by Pilot as assets for purposes of the Annual Statement, and also for purposes of the Federal income tax returns. Only the treatment of the escrow funds held by mortgage correspondents in Puerto Rico and Virginia is at issue herein.

187. With respect to FHA mortgages serviced by Banco Creditor and McClaine Properties, Pilot used a deed of trust form, or a form of mortgage containing similar provisions which provided in part:

> "And the said party of the first part, in order more fully to protect the security of this Deed of Trust, does hereby covenant and agree as follows:
>
> "1. That he will promptly pay the principal of and interest on the indebtedness evidenced by the said note, at the times and in the manner therein provided . . .
>
> "2. That, together with and in addition to the monthly payment of principal and interest payable under

the terms of the note secured hereby, he will pay to the holder of the note, on the first day of each month until it is fully paid, the following sums:

"(a) If this Deed of Trust and the note secured hereby are insured under the provisions of the National Housing Act and so long as they continue to be so insured, one-twelfth (1/12) of the annual mortgage insurance premium for the purpose of putting the holder thereof in funds with which to discharge the holder's obligation to the Federal Housing Commissioner for mortgage insurance premiums pursuant to the applicable provisions of the National Housing Act, as amended, and Regulations thereunder. The holder of the note shall, on the termination of its obligation to pay mortgage insurance premiums, credit to the account of the party of the first part all payments made under the provisions of this subsection which the holder of the note has not become obligated to pay to the Federal Housing Commissioner.

"(b) A sum equal to the ground rents, if any, next due, plus the premiums that will next become due and payable on policies of fire and other hazard insurance covering the mortgaged property, plus taxes and assessments next due on the mortgaged property (all as estimated by the holder of the note) less all sums already paid therefor divided by the number of months to elapse before one month prior to the date when such ground rents, premiums, taxes, and assessments will become delinquent, such sums to be held by the holder of the note in trust to pay said ground rents, premiums, taxes, and special assessments.

"(c) All payments mentioned in the two preceding subsections of the paragraph and all payments to be made under the note secured hereby shall be added together and the aggregate amount thereof shall be paid by the party of the first part each month in a

single payment to be applied by the holder of the note to the following items in the order set forth:

"(I) premium charges under the contract of insurance with the Federal Housing Commissioner;

"(II) ground rents, taxes, special assessments, fire, and other hazard insurance premiums;

"(III) interest on the note secured hereby; and

"(IV) amortization of the principal of said note."

188. Plaintiff's Exhibit 37 is a deed of trust form customarily used by Pilot in making non-FHA mortgage loans in the State of Virginia which were serviced under the McClaine Properties agreement. The deed of trust contained the following provision:

"And the parties of the first part hereof agree to pay monthly, in addition to the above, a sum equal to the estimated amount of taxes and special assessments next due on the premises covered by this deed of trust less all sums already paid therefor, divided by the number of months to elapse before one month prior to the date when such taxes and/or assessments will become due, such sum to be held by the Pilot Life Insurance Company or its designated agent in trust to pay said taxes and/or special assessments when the same become due, adjustment to be made when actual amount of such taxes and assessments are ascertained."

189. Plaintiff's Exhibit 41 is a mortgage form customarily used by Pilot in making non-FHA loans in Puerto Rico, which was serviced under the Banco Credito agreement. The mortgage contains the following provisions:

"The mortgagors as of this date have subscribed a promissory note in the sum of SIXTEEN THOUSAND DOLLARS ($16,000.00) with interest at the rate of six per cent (6%) per annum until the total satisfac-

tion of the same, payable to Pilot Life Insurance Company, or order, the principal and interest being payable in monthly installments of ONE HUNDRED THIRTY-FIVE DOLLARS AND TWO CENTS ($135.02), and an additional monthly sum of FORTY-ONE DOLLARS AND EIGHTY-TWO CENTS ($41.82) as an escrow deposit for the payment of taxes and hazard insurance premiums, making a total monthly payment of ONE HUNDRED SEVENTY-SIX DOLLARS AND EIGHTY-FOUR CENTS ($176.84). . . ."

190. Pilot's treatment of the mortgage correspondents' escrow fund at issue herein as "admitted assets" for purposes of the Annual Statements was not disapproved by the N.A.I.C. examiners in 1961.

191. The foregoing amounts were reflected on line 13 of exhibit 13, found on page 14 of the Annual Statements submitted to the Insurance Department of North Carolina for each of the years 1955 through 1959 as "ledger assets" and as "admitted assets."

192. In computing its taxable investment income for Federal tax purposes, Pilot did not include the amount of escrow funds held by its mortgage correspondents in assets.

XII

Nonparticipating Contracts

193. Increases in a life insurance company's reserves are generally attributable to either (1) normal additions made each year to fund the existing and increasing obligations under policies in force; or (2) additions required when a method of assumption used in calculating policy reserves is changed so as to produce a higher reserve. The latter or less usual occurrence is called "reserve strengthening."

194. The dollar amount of the increase in reserve resulting solely from this change in method or assumption is the amount of the reserve strengthening.

195. In the year 1959, plaintiffs strengthened all life reserves, including those attributable to nonparticipating contracts, to net level premium reserves.

196. Nonparticipating contracts are life insurance and annuity contracts in which the policyholders do not participate in company earnings or receive dividends. The nonparticipating contracts pertinent to the issue in this suit are those of the type described in Section 809(d)(5) of the Code, and are referred to hereinafter as nonparticipating contracts.

197. In 1959 the total increase in reserves of Jefferson and Pilot, attributable to such nonparticipating contracts, was $19,620,094.00. Of this amount, $8,081,566.00 resulted from reserve strengthening in 1959 in the reserves attributable to those nonparticipating policies (consisting of $4,057,034.00 as to Jefferson and $4,024,532.00 as to Pilot). The remainder of the $19,620,094.00 constituted normal reserve increases attributable to nonparticipating contracts.

198. In the consolidated tax return filed for the year 1959, Jefferson, at Schedule E, line 25b, took a deduction of $1,962,009.00 attributable to increases in reserves for nonparticipating contracts.

199. This deduction constituted a full 10% of the total increase in reserves in 1959 (including the increase resulting from the reserve strengthening) attributable to such nonparticipating contracts.

200. The Commissioner adjusted such deduction downward to $1,153,853.00.

201. The difference of $808,156.00 constitutes the deduction taken by Jefferson attributable to reserve strengthening on such nonparticipating contracts. This is a full

10% of the reserve increase of $8,081,566.00 attributable to reserve strengthening for such nonparticipating contracts.

202. The Commissioner held that the portion of the reserve increases on nonparticipating contracts attributable to normal increases in reserves is to be reflected in the year of the increase, but that the portion of the reserve increases on nonparticipating contracts attributable to reserve strengthening is to be reflected ratably over a ten-year period, starting in the year after the strengthening occurs.

203. Plaintiff's Exhibit 45 illustrates the operation of the nonparticipating contract deduction, and the opposing positions of the parties. This illustration assumes a nonparticipating whole life contract in the amount of $1,000.00 issued in the year 1950 at age 35 with a reserve based upon the 1941 Commissioner's Standard Ordinary Mortality Table with interest at three per cent. Assuming that the December 31, 1958, reserve was calculated according to the Commissioner's Reserve Valuation Method, and that the December 31, 1959, reserve was strengthened by changing the method of calculation to the Net Level Reserve Method, the resulting figures would be as follows:

(a) Under the Commissioner's Reserve Valuation Method, the reserve as of December 31, 1958, would be $134.00, and the reserve as of December 31, 1959, would be $151.00.

(b) Under the Net Level Reserve Method, the reserve as of December 31, 1959, would be $164.00. The excess of the December 31, 1959, reserve over the December 31, 1958, reserve would be $30.00 (i.e., $164.00 less $134.00). Of this increase, $13.00 (i.e., $164.00 less $151.00) arises because the method of valuing the reserves was changed from the Commissioner's Reserve Valuation Method to the Net Level Reserve Method. Under Jefferson's position, the deduction for the increase in nonparticipating reserves for

the year 1959 would be based upon an increase in reserves amounting to $30.00. Under the defendant's position, the deduction would be based on an increase of $17.00 (i.e., $30.00 less $13.00). The deduction claimed by Jefferson and calculated from this increase in reserves would be ten per cent of $30.00, or $3.00, in the current year. The defendant claims that the deduction should be ten per cent of the $17.00 in the current year (i.e., $1.70), and that ten per cent of the balance of the total increase of $13.00, or $1.30, should be taken into account in the computations over the next ten years at the rate of 13 cents in each year.

204. The three per cent of premiums computation provided in Section 809(d)(5) of the Code was not applicable to Jefferson with respect to the year 1959.

CONCLUSIONS OF LAW

I

General

1. The Court has jurisdiction of the parties and of the subject matter.

II

The Applicable Rate of Tax

2. For the years 1958 and 1959, Jefferson was subject to the additional 2 per-cent tax incident to its privilege of filing consolidated returns.

III

Determination of Consolidated Taxable Income

3. Intercompany dividends paid by Pilot to Jefferson were not income for purposes of the consolidated income tax returns of the two companies.

4. The intercompany investment of Jefferson in the stock of Pilot was not an asset for purposes of the consolidated income tax returns of the two companies.

5. In the computation of consolidated taxable investment income for purposes of Section 804 for the years 1958 and 1959, intercompany dividends paid by Pilot to Jefferson in such years were properly eliminated from gross investment income in their entirety, and no reduction should be made in the amount of Jefferson's consolidated policy and other contract liability requirements by reason of such elimination.

6. In the computation of consolidated gain from operations for purposes of Section 809 for the years 1958 and 1959, intercompany dividends were properly eliminated from gross investment income in their entirety and no reduction should be made in the amount of Jefferson's consolidated required interest for purposes of the computation required by Section 809(a)(1) by reason of such elimination.

7. For the years 1958 and 1959, the consolidating methods and procedures employed by Jefferson in determining taxable investment income, gain from operations, policy and other contract liability requirements, adjusted reserves rates, investment yield and required interest, for purposes of income tax returns, were proper.

IV

Branch Office Managers Supplemental Retirement Plan

8. The amount set aside by Jefferson for the purpose of future benefits which it might have to pay under its Branch Office Managers Supplemental Retirement Plan did not constitute the life insurance and annuity reserves referred to in Section 801(b) of the Code.

V

Computations for Annual Statement

9. With respect to the years 1958 and 1959, in making computations required for purposes of the Annual Statement form approved by the N.A.I.C., Jefferson employed an accrual method of accounting.

10. Life insurance companies are specifically authorized by Section 818(a) of the Code to employ an "accrual method of accounting" in computing income tax liability, and to make such computations "consistent with the manner required for purposes of the annual statement approved by the National Association of Insurance Commissioners."

11. The form of the Annual Statement prescribed by the N.A.I.C. may only be used, however, in computing taxable income when it does not conflict with an accrual method of accounting and is not inconsistent with the provisions of the Internal Revenue Code, or the regulations thereunder.

VI

Unearned Investment Income

12. Consistent with the provisions of Section 818(a) of the Code, Jefferson computed its income under an accrual method of accounting.

13. Prepaid investment income, including rents and interest, although unearned, is includable in income when received or credited, and is taxable to an accrual basis taxpayer in the year of receipt. *Schlude* v. *Commissioner*, 372 U.S. 128 (1963).

14. The Commissioner did not abuse his discretion when he disallowed the deferral of unearned investment income in the manner claimed by Jefferson on its 1958 and 1959 tax returns.

VII

Charitable Contributions

15. The charitable contributions allocated by Jefferson and Pilot to investment expense in the years 1958 and 1959 were general expenses properly and reasonably assigned to investment expenses.

16. Such contributions were deductions from gross investment income, pursuant to Section 804(c)(1) of the Code, in arriving at investment yield for purposes of determining consolidated taxable investment income.

VIII

Increase in Loading on Deferred and Uncollected Premiums

17. Jefferson properly included in income for 1958 and 1959 the gross amount of all premiums, including the gross amount of deferred and uncollected life insurance premiums and the gross amount of accident and health insurance premiums due and unpaid.

18. In making computations entering into the determination of gain from operations, Congress has made no provision for the deduction of increases in loading on deferred and uncollected premiums as an underwriting expense. Items properly deductible in computing gain from operations by life insurance companies are limited to those specified in Section 809(d) of the Code.

19. The Commissioner of Internal Revenue correctly disapproved Jefferson's attempt to deduct from its gross premium income an amount referred to as "increase in loading" on deferred and uncollected premiums.

IX

Deferred and Uncollected Premiums as Assets; Due and Unpaid Premiums as Assets

20. Deferred and uncollected premiums of Jefferson and Pilot are assets, other than real and personal property, used in carrying on an insurance trade or business, within the meaning of Section 805(b)(4) of the Code. Treasury Regulations, Section 1.805-5(a)(4).

21. Due and unpaid accident and health premiums are assets of Pilot, other than real and personal property, used by it in carrying on an insurance trade or business, within the meaning of Section 805(b)(4) of the Code, Treasury Regulations, Section 1.805-5(a)(4).

22. The amount of deferred and uncollected premiums of Jefferson and Pilot, including amounts of loading, and the amount of due and unpaid premiums of Pilot, including amounts of loading, are includable as assets in computing the earning rates of Jefferson and Pilot.

X

Agents' Debit Balances

23. The agents' debit balances of Jefferson and Pilot are "assets" within the meaning of Section 805(b)(4) of the Code.

XI

Mortgage Correspondent Escrow Funds

24. The term "assets" used in Section 805(b)(4) of the Code embraces only "assets of the company."

25. The mortgage correspondent escrow funds involved in these actions were segregated and held in trust for the benefit of borrowers or mortgagors, and hence were not assets of Pilot for purposes of 805(b)(4) of the Code.

XII

Nonparticipating Contracts

26. For the year 1959, plaintiff, as provided by Section 809(d)(5) of the Code, is entitled to a deduction relating to nonparticipating contracts in the full amount of the full increase in reserves during the year, including any increase resulting from reserve strengthening. The deduction provided by Section 809(d)(5) is in addition to the deduction provided by Section 809(d)(2) for increases in reserves, and Section 810(d) applies only to Section 809(d)(2).

Any conclusion contained in Conclusions of Law herein, which may properly be construed in whole or in part as a finding of fact, shall be so deemed and treated as if specifically set forth in the Findings of Fact.

Any finding contained in the Findings of Fact herein, which may properly be construed in whole or in part as a conclusion of law, shall be so deemed and treated as if specifically set forth in the Conclusions of Law.

Counsel for the defendant shall prepare and present to the Court, after first having obtained the endorsement of counsel for the plaintiff showing approval as to form, a judgment in conformity herewith. The judgment shall allow necessary adjustments to Jefferson's tax liability for the years 1958 and 1959 on the basis of computations to be made by the parties. In the event the parties are unable to agree upon such computations, and the other terms of a final judgment, within forty days from the date hereof, they shall submit their dispute to the Court.

/s/ EDWIN M. STANLEY
United States District Judge

August 15, 1967

STATUTES

Internal Revenue Code of 1954 (as Applicable to the Taxable Years 1958 and 1959):

SEC. 11. TAX IMPOSED.

(a) CORPORATIONS IN GENERAL.—A tax is hereby imposed for each taxable year on the taxable income of every corporation. The tax shall consist of a normal tax computed under subsection (b) and a surtax computed under subsection (c).

* * *

(c) SURTAX.—The surtax is equal to 22 percent of the amount by which the taxable income (computed without regard to the deduction, if any, provided in section 242 for partially tax-exempt interest) exceeds $25,000.

(d) EXCEPTIONS.—Subsection (a) shall not apply to a corporation subject to a tax imposed by—

* * *

(2) subchapter L (sec. 801 and following, relating to insurance companies), or

* * *

SEC. 170. CHARITABLE, ETC., CONTRIBUTIONS AND GIFTS.

(a) ALLOWANCE OF DEDUCTION:—

(1) GENERAL RULE.—There shall be allowed as a deduction any charitable contribution (as defined in subsection (c)) payment of which is made within the taxable year. A charitable contribution shall be allowable as a deduction only if verified under regulations prescribed by the Secretary or his delegate.

* * *

(b) LIMITATIONS.—

* * *

(2) subchapter L (sec. 801 and following, relating to insurance companies), or

not exceed 5 percent of the taxpayer's taxable income computed without regard to—

(A) this section,

(B) part VII (except section 248),

(C) any net operating loss carryback to the taxable year under section 172, and

(D) section 922 (special deduction for Western Hemisphere trade corporations).

* * *

SEC. 446. GENERAL RULE FOR METHODS OF ACCOUNTING.

(a) GENERAL RULE.—Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.

(b) EXCEPTIONS.—If no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary or his delegate, does clearly reflect income.

(c) PERMISSIBLE METHODS.—Subject to the provisions of subsections (a) and (b), a taxpayer may compute taxable income under any of the following methods of accounting—

(1) the cash receipts and disbursements method;

(2) an accrual method;

(3) any other method permitted by this chapter; or

(4) any combination of the foregoing methods permitted under regulations prescribed by the Secretary or his delegate.

(d) TAXPAYER ENGAGED IN MORE THAN ONE BUSINESS.—A taxpayer engaged in more than one trade or business

may, in computing taxable income, use a different method of accounting for each trade or business.

(e) REQUIREMENT RESPECTING CHANGE OF ACCOUNTING METHOD.—Except as otherwise expressly provided in this chapter, a taxpayer who changes the method of accounting on the basis of which he regularly computes his income in keeping his books shall, before computing his taxable income under the new method, secure the consent of the Secretary or his delegate.

SEC. 451. GENERAL RULE FOR TAXABLE YEAR OF INCLUSION.

(a) GENERAL RULE.—The amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period.

* * *

SEC. 801. DEFINITION OF LIFE INSURANCE COMPANY.

* * *

(b) LIFE INSURANCE RESERVES DEFINED.—

(1) IN GENERAL.—For purposes of this part, the term "life insurance reserves" means amounts—

(A) which are computed or estimated on the basis of recognized mortality or morbidity tables and assumed rates of interest, and

(B) which are set aside to mature or liquidate, either by payment or reinsurance, future unaccrued claims arising from life insurance, annuity, and noncancellable health and accident insurance contracts (including life insurance or annuity contracts combined with noncancellable health and accident insurance) involving, at the time with respect to which the reserve is computed, life, health, or accident contingencies.

(2) RESERVES MUST BE REQUIRED BY LAW.—Except—

(A) in the case of policies covering life, health, and accident insurance combined in one policy issued on the weekly premium payment plan, continuing for life and not subject to cancellation,

(B) in the case of policies issued by an organization which meets the requirements of section 501(c)(9) other than the requirement of subparagraph (B) thereof, and

(C) as provided in paragraph (3),

in addition to the requirements set forth in paragraph (1), life insurance reserves must be required by law.

(3) ASSESSMENT COMPANIES.—In the case of an assessment life insurance company or association, the term "life insurance reserves" includes—

(A) sums actually deposited by such company or association with State or Territorial officers pursuant to law as guaranty or reserve funds, and

(B) any funds maintained, under the charter or articles of incorporation or association (or bylaws approved by a State insurance commissioner) of such company or association, exclusively for the payment of claims arising under certificates of membership or policies issued on the assessment plan and not subject to any other use.

For purposes of this part, the rate of interest assumed in calculating the reserves described in subparagraphs (A) and (B) shall be 3 percent.

(4) DEFICIENCY RESERVES EXCLUDED.—The term "life insurance reserves" does not include deficiency reserves. For purposes of this subsection and subsection (c), the deficiency reserve for any contract is that portion of the reserve for such contract equal to the amount (if any) by which—

(A) the present value of the future net premiums required for such contract, exceeds

(B) the present value of the future actual premiums and consideration charged for such contract.

(5) AMOUNT OF RESERVES.—For purposes of this subsection, subsection (a), and subsection (c), the amount of any reserve (or portion thereof) for any taxable year shall be the mean of such reserve (or portion thereof) at the beginning and end of the taxable year.

* * *

SEC. 802. TAX IMPOSED.

(a) TAX IMPOSED.—

(1) IN GENERAL.—A tax is hereby imposed for each taxable year beginning after December 31, 1957, on the life insurance company taxable income of every life insurance company. Such tax shall consist of—

(A) a normal tax on such income computed at the rate provided by section 11(b), and

(B) a surtax, on so much of such income as exceeds $25,000, computed at the rate provided by section 11(c).

(2) TAX IN CASE OF CAPITAL GAINS.—If for any taxable year beginning after December 31, 1958, the net long-term capital gain of any life insurance company exceeds the net short-term capital loss, there is hereby imposed a tax equal to 25 percent of such excess.

* * *

(b) LIFE INSURANCE COMPANY TAXABLE INCOME DEFINED.—For purposes of this part, the term "life insurance company taxable income" means the sum of—

(1) the taxable investment income (as defined in section 804) or, if smaller, the gain from operations (as defined in section 809),

(2) if the gain from operations exceeds the taxable investment income, an amount equal to 50 percent of such excess, plus

(3) the amount subtracted from the policyholders surplus account for the taxable year, as determined under section 815.

* * *

SEC. 804. TAXABLE INVESTMENT INCOME.

(a) IN GENERAL.—

(1) EXCLUSION OF POLICYHOLDERS' SHARE OF INVESTMENT YIELD.—The policyholders' share of each and every item of investment yield (including tax-exempt interest, partially tax-exempt interest, and dividends received) of any life insurance company shall not be included in taxable investment income. For purposes of the preceding sentence, the policyholders' share of any item shall be that percentage obtained by dividing the policy and other contract liability requirements by the investment yield; except that if the policy and other contract liability requirements exceed the investment yield, then the policyholders' share of any item shall be 100 percent.

* * *

(6) EXCEPTION.—If it is established in any case that the application of the definition of taxable investment income contained in paragraph (2) results in the imposition of tax on—

(A) any interest which under section 103 is excluded from gross income,

(B) any amount of interest which under section 242 (as modified by paragraph (3) is allowable as a deduction, or

(C) any amount of dividends received which under sections 243, 244, and 245 (as modified by paragraph (5)) is allowable as a deduction,

adjustment shall be made to the extent necessary to prevent such imposition.

* * *

(c) INVESTMENT YIELD DEFINED.—For purposes of this part, the term "investment yield" means the gross investment income less the following deductions—

(1) INVESTMENT EXPENSES.—Investment expenses for the taxable year. If any general expenses are in part assigned to or included in the investment expenses, the total deduction under this paragraph shall not exceed the sum of—

(A) one-fourth of one percent of the mean of the assets (as defined in section 805(b)(4)) held at the beginning and end of the taxable year,

(B) the amount of the mortgage service fees for the taxable year, plus

(C) whichever of the following is the greater:

(i) one-fourth of the amount by which the investment yield (computed without any deduction for investment expenses allowed by this paragraph) exceeds 3¾ percent of the mean of the assets (as defined in section 805(b)(4)) held at the beginning and end of the taxable year, reduced by the amount described in subparagraph (B), or

(ii) one-fourth of one percent of the mean of the value of mortgages held at the beginning and end of the taxable year for which there are no mortgage service fees for the taxable year.

* * *

SEC. 805. POLICY AND OTHER CONTRACT LIABILITY REQUIREMENTS.

(a) IN GENERAL.—For purposes of this part, the term "policy and other contract liability requirements" means, for any taxable year, the sum of—

(1) the adjusted life insurance reserves, multiplied by the adjusted reserves rate,

(2) the mean of the pension plan reserves at the beginning and end of the taxable year, multiplied by the current earnings rate, and

(3) the interest paid.

(b) ADJUSTED RESERVES RATE AND EARNINGS RATES.—

(1) ADJUSTED RESERVES RATE.—For purposes of this part, the adjusted reserves rate for any taxable year is the average earnings rate or, if lower, the current earnings rate.

(2) CURRENT EARNINGS RATE.—For purposes of this part, the current earnings rate for any taxable year is the amount determined by dividing—

(A) the taxpayer's investment yield for such taxable year, by

(B) the mean of the taxpayer's assets at the beginning and end of the taxable year.

(3) AVERAGE EARNINGS RATE.—

(A) IN GENERAL.—For purposes of this part, the average earnings rate for any taxable year is the average of the current earnings rates for such taxable year and for each of the 4 taxable years immediately preceding such taxable year (excluding any of such 4 taxable years for which the taxpayer was not an insurance company).

(B) SPECIAL RULES.—For purposes of subparagraph (A)—

(i) the current earnings rate for any taxable year beginning before January 1, 1958, shall be determined as if this part (as in effect for 1958) and section 381(c)(22) applied to such taxable year, and

(ii) the current earnings rate for any taxable year of any company which, for such year, is an insurance company (but not a life insurance company) shall

be determined as if this part applied to such company for such year.

(4) ASSETS.—For purposes of this part, the term "assets" means all assets of the company (including nonadmitted assets), other than real and personal property (excluding money) used by it in carrying on an insurance trade or business. For purposes of this paragraph, the amount attributable to—

(A) Real property and stock shall be the fair market value thereof, and

(B) any other asset shall be the adjusted basis (determined without regard to fair market value on December 31, 1958) of such asset for purposes of determining gain on sale or other disposition.

(c) ADJUSTED LIFE INSURANCE RESERVES.—

(1) ADJUSTED LIFE INSURANCE RESERVES DEFINED.—For purposes of this part, the term "adjusted life insurance reserves" means—

(A) the mean of the life insurance reserves (as defined in section 801(b)), other than pension plan reserves, at the beginning and end of the taxable year, multiplied by

(B) that percentage which equals 100 per cent—

(i) increased by that percentage which is 10 times the average rate of interest assumed by the taxpayer in calculating such reserves, and

(ii) reduced by that percentage which is 10 times the adjusted reserves rate.

* * * * *

(d) PENSION PLAN RESERVES.—

(1) PENSION PLAN RESERVES DEFINED.—For purposes of this part, the term "pension plan reserves" means that

portion of the life insurance reserves which is allocable to contracts—

(A) purchased under contracts entered into with trusts which (as of the time the contracts were entered into) were deemed to be (i) trusts described in section 401(a) and exempt from tax under section 501(a), or (ii) trusts exempt from tax under section 165 of the Internal Revenue Code of 1939 or the corresponding provisions of prior revenue laws;

(B) purchased under contracts entered into under plans which (as of the time the contracts were entered into) were deemed to be plans meeting the requirements of section 401(a)(3), (4), (5), and (6), or the requirements of section 165(a)(3), (4), (5), and (6) of the Internal Revenue Code of 1939;

(C) provided for employees of the life insurance company under a plan which, for the taxable year, meets the requirements of section 401(a)(3), (4), (5), and (6); or

(D) purchased to provide retirement annuities for its employees by an organization which (as of the time the contracts were purchased) was an organization described in section 501(c)(3) which was exempt from tax under section 501(a) or was an organization exempt from tax under section 101(6) of the Internal Revenue Code of 1939 or the corresponding provisions of prior revenue laws.

(2) SPECIAL TRANSITIONAL RULE.—For purposes of this part, the amount taken into account as pension plan reserves shall be—

(A) in the case of a taxable year beginning after December 31, 1957, and before January 1, 1959, zero;

(B) in the case of a taxable year beginning after December 31, 1958, and before January 1, 1960, 33⅓ percent of the amount thereof (determined without regard to this paragraph);

(C) in the case of a taxable year beginning after December 31, 1959, and before January 1, 1961, 66⅔ percent of the amount thereof (determined without regard to this paragraph); and

(D) in the case of a taxable year beginning after December 31, 1960, 100 percent of the amount thereof.

* * *

SEC. 809. IN GENERAL.

(a) EXCLUSION OF SHARE OF INVESTMENT YIELD SET ASIDE FOR POLICYHOLDERS.—

(1) AMOUNT.—The share of each and every item of investment yield (including tax-exempt interest, partially tax-exempt interest, and dividends received) of any life insurance company set aside for policyholders shall not be included in gain or loss from operations. For purposes of the preceding sentence, the share of any item set aside for policyholders shall be that percentage obtained by dividing the required interest by the investment yield; except that if the required interest exceeds the investment yield, then the share of any item set aside for policyholders shall be 100 percent.

(2) REQUIRED INTEREST.—For purposes of this part, the required interest for any taxable year is the sum of the products obtained by multiplying—

(A) each rate of interest required, or assumed by the taxpayer, in calculating the reserves described in section 810(c), by

(B) the means of the amount of such reserves computed at that rate at the beginning and end of the taxable year.

(b) GAIN AND LOSS FROM OPERATIONS.—

(1) GAIN FROM OPERATIONS DEFINED.—For purposes of this part, the term "gain from operations" means the amount by which the sum of the following exceeds the deductions provided by subsection (d):

(A) the life insurance company's share of each and every item of investment yield (including tax-exempt interest, partially tax-exempt interest, and dividends received); and

(B) the sum of the items referred to in subsection (c).

(2) LOSS FROM OPERATIONS DEFINED.—For purposes of this part, the term "loss from operations" means the amount by which the sum of the deductions provided by subsection (d) exceeds the sum of—

(A) the life insurance company's share of each and every item of investment yield (including tax-exempt interest, partially tax-exempt interest, and dividends received); and

(B) the sum of the items referred to in subsection (c).

(3) LIFE INSURANCE COMPANY'S SHARE.—For purposes of this subpart, the life insurance company's share of any item shall be that percentage which, when added to the percentage obtained under the second sentence of subsection (a)(1), equals 100 percent.

(4) EXCEPTION.—If it is established in any case that the application of the definition of gain from operations contained in paragraph (1) results in the imposition of tax on—

(A) any interest which under section 103 is excluded from gross income,

(B) any amount of interest which under section 242 (as modified by section 804(a)(3)) is allowable as a deduction, or

(C) any amount of dividends received which under sections 243, 244, and 245 (as modified by subsection (d)(8)(B)) is allowable as a deduction,

adjustment shall be made to the extent necessary to prevent such imposition.

(c) GROSS AMOUNT.—For purposes of subsections (b) (1) and (2), the following items shall be taken into account:

(1) PREMIUMS.—The gross amount of premiums and other consideration (including advance premiums, deposits, fees, assessments, and consideration in respect of assuming liabilities under contracts not issued by the taxpayer) on insurance and annuity contracts (including contracts supplementary thereto); less return premiums, and premiums and other consideration arising out of reinsurance ceded. Except in the case of amounts of premiums or other consideration returned to another life insurance company in respect of reinsurance ceded, amounts returned where the amount is not fixed in the contract but depends on the experience of the company or the discretion of the management shall not be included in return premiums.

(2) DECREASES IN CERTAIN RESERVES.—Each net decrease in reserves which is required by section 810 or 811(b)(2) to be taken into account for purposes of this paragraph.

(3) OTHER AMOUNTS.—All amounts, not included in computing investment yield and not includible under paragraph (1) or (2), which under this subtitle are includible in gross income.

Except as included in computing investment yield, there shall be excluded any gain from the sale or exchange of a capital asset, and any gain considered as gain from the sale or exchange of a capital asset.

(d) DEDUCTIONS.—For purposes of subsections (b) (1) and (2), there shall be allowed the following deductions:

* * *

(12) OTHER DEDUCTIONS.—Subject to the modifications provided by subsection (e), all other deductions allowed under this subtitle for purposes of computing taxable in-

come to the extent not allowed as deductions in computing investment yield.

Except as provided in paragraph (3), no amount shall be allowed as a deduction under this subsection in respect of dividends to policyholders.

(e) MODIFICATIONS.—The modifications referred to in subsection (d)(12) are as follows:

* * *

(3) CHARITABLE, ETC., CONTRIBUTIONS AND GIFTS.—In applying section 170—

(A) the limit on the total deductions under such section provided by the first sentence of section 170(b)(2) shall be 5 percent of the gain from operations computed without regard to—

(i) the deduction provided by section 170,

(ii) the deductions provided by paragraphs (3), (5), (6), and (8) of subsection (d), and

(iii) any operations loss carryback to the taxable year under section 812; and

(B) under regulations prescribed by the Secretary or his delegate, a rule similar to the rule contained in section 170(b)(3) shall be applied.

* * *

(f) LIMITATION ON CERTAIN DEDUCTIONS.—

(1) IN GENERAL.—The amount of the deductions under paragraphs (3), (5), and (6) of subsection (d) shall not exceed $250,000 plus the amount (if any) by which—

(A) the gain from operations for the taxable year, computed without regard to such deductions, exceeds

(B) the taxable investment income for the taxable year.

(2) APPLICATION OF LIMITATION.—The limitation provided by paragraph (1) shall apply first to the amount of the de-

duction under subsection (d)(6), then to the amount of the deduction under subsection (d)(5), and finally to the amount of the deduction under subsection (d)(3).

* * *

SEC. 818. ACCOUNTING PROVISIONS.

(a) METHOD OF ACCOUNTING.—All computations entering into the determination of the taxes imposed by this part shall be made—

(1) under an accrual method of accounting, or

(2) to the extent permitted under regulations prescribed by the Secretary or his delegate, under a combination of an accrual method of accounting with any other method permitted by this chapter (other than the cash receipts and disbursements method).

Except as provided in the preceding sentence, all such computations shall be made in a manner consistent with the manner required for purposes of the annual statement approved by the National Association of Insurance Commissioners.

* * *

SEC. 832. INSURANCE COMPANY TAXABLE INCOME.

* * *

(b) DEFINITIONS.—In the case of an insurance company subject to the tax imposed by section 831—

(1) GROSS INCOME.—The term "gross income" means the sum of—

(A) the combined gross amount earned during the taxable year, from investment income and from underwriting income as provided in this subsection, computed on the basis of the underwriting and investment exhibit of the annual statement approved by the National Convention of Insurance Commissioners,

* * *

SEC 1501. PRIVILEGE TO FILE CONSOLIDATED RETURNS.

An affiliated group of corporations shall, subject to the provisions of this chapter, have the privilege of making a consolidated return with respect to the income tax imposed by chapter 1 for the taxable year in lieu of separate returns. The making of a consolidated return shall be upon the condition that all corporations which at any time during the taxable year have been members of the affiliated group consent to all the consolidated return regulations prescribed under section 1502 prior to the last day prescribed by law for the filing of such return. The making of a consolidated return shall be considered as such consent. In the case of a corporation which is a member of the affiliated group for a fractional part of the year, the consolidated return shall include the income of such corporation for such part of the year as it is a member of the affiliated group.

SEC. 1502. REGULATIONS.

The Secretary or his delegate shall prescribe such regulations as he may deem necessary in order that the tax liability of an affiliated group of corporations making a consolidated return and of each corporation in the group, both during and after the period of affiliation, may be returned, determined, computed, assessed, collected, and adjusted, in such manner as clearly to reflect the income tax liability and the various factors necessary for the determination of such liability, and in order to prevent avoidance of such tax liability.

SEC. 1503. COMPUTATION AND PAYMENT OF TAX.

(a) GENERAL RULE.—In any case in which a consolidated return is made or is required to be made, the tax shall be determined, computed, assessed, collected, and adjusted, in accordance with the regulations under section 1502 prescribed prior to the last day prescribed by law for the filing of such return; except that the tax imposed under section 11(c) or section 831 shall be increased for any taxable year

by 2 percent of the consolidated taxable income of the affiliated group of includible corporations. For purposes of this section, the term "consolidated taxable income" means the consolidated taxable income computed without regard to the deduction provided by section 242 for partially tax-exempt interest.

* * *

Internal Revenue Code of 1939:

SEC. 204. INSURANCE COMPANIES OTHER THAN LIFE OR MUTUAL.

* * *

(b) DEFINITION OF INCOME, ETC.—In the case of an insurance company subject to the tax imposed by this section—

(1) GROSS INCOME.—"Gross income" means the sum of (A) the combined gross amount earned during the taxable year, from investment income and from underwriting income as provided in this subsection, computed on the basis of the underwriting and investment exhibit of the annual statement approved by the National Convention of Insurance Commissioners, and (B) gain during the taxable year from the sale or other disposition of property, and (C) all other items constituting gross income under section 22; except that in the case of a mutual fire insurance company described in paragraph (1) of subsection (a) of this section, the amount of single deposit premiums paid to such company shall not be included in gross income;

* * *

General Statutes of North Carolina:

SEC. 58-72. KINDS OF INSURANCE AUTHORIZED.—The kinds of insurance which may be authorized in this State, subject to the other provisions of this chapter, are set forth in the following paragraphs . . . .

(1) * * * *

(2) "Annuities," meaning all agreements to make periodical payments where the making or continuance of all or of some of a series of such payments, or the amount of any such payment, is dependent upon the continuance of human life, except payments made under the authority of subdivision (1).

SEC. 58-201. RESERVE FUND OF DOMESTIC COMPANIES TO BE CALCULATED.—The valuation of the reserves on the policies and bonds of every life insurance company incorporated by the laws of this State shall be based upon any recognized standard of valuation and mortality table as the Commissioner should deem best for the security of the business and the safety of the persons insured. The Commissioner shall annually value or cause to be valued the reserves on all policies and annuities of each domestic company and may accept the valuation of such reserves made by the company upon such evidence of its correctness as he may require . . . .

SEC. 58-201.1. STANDARD VALUATION LAW.—(a) This section shall be known as the Standard Valuation Law.

(b) The Commissioner shall annually value, or cause to be valued, the reserve liabilities (hereinafter called reserves) for all outstanding life insurance policies and annuity and pure endowment contracts of every life insurance company doing business in this State, and may certify the amount of such reserves, specifying the mortality table or tables, rate or rates of interest and methods (net level premium method or other) used in the calculation of such reserves . . . .

(c) The minimum standard for the valuation of all such policies and contracts issued prior to the operative date of § 58-201.2 shall be that provided by the laws in effect immediately prior to such date. The minimum standard for the valuation of all such policies and contracts issued on or after the operative date of § 58-201.2 shall be the Commis-

sioner's reserve valuation method defined in subsection (d), three and one-half per cent (3½%) interest, and the following tables:

* * *

(3) For annuity and pure endowment contracts, excluding any disability and accidental death benefits in such policies, the 1937 Standard Annuity Mortality Table.

* * *

(Vol. 2B, General Statutes of North Carolina, 1960 Comp.)

TREASURY REGULATIONS

§ 1.446.1. GENERAL RULE FOR METHODS OF ACCOUNTING—(a) * * *

(2) It is recognized that no uniform method of accounting can be prescribed for all taxpayers. Each taxpayer shall adopt such forms and systems as are, in his judgment, best suited to his needs. However, no method of accounting is acceptable unless, in the opinion of the Commissioner, it clearly reflects income. A method of accounting which reflects the consistent application of generally accepted accounting principles in a particular trade or business in accordance with accepted conditions or practices in that trade or business will ordinarily be regarded as clearly reflecting income, provided all items of gross income and expenses are treated consistently from year to year.

* * *

(c) *Permissible methods.* (1) *In general.* Subject to the provisions of paragraphs (a) and (b) of this section, a taxpayer may compute his taxable income under any of the following methods of accounting:

(i) *Cash receipts and disbursements method.* Generally, under the cash receipts and disbursements method in the computation of taxable income, all items which constitute

gross income (whether in the form of cash, property, or services) are to be included for the taxable year in which actually or constructively received. Expenditures are to be deducted for the taxable year in which actually made. For rules relating to constructive receipt, see § 1.451-2. For treatment of an expenditure attributable to more than one taxable year, see section 461(a) and § 1.461-1(a)(1).

(ii) *Accrual method.* Generally, under an accrual method, income is to be included for the taxable year when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. Under such a method, deductions are allowable for the taxable year in which all the events have occurred which establish the fact of the liability giving rise to such deduction and the amount thereof can be determined with reasonable accuracy. The method used by the taxpayer in determining when income is to be accounted for will be acceptable if it accords with generally recognized and accepted income tax accounting principles and is consistently used by the taxpayer from year to year. For example, a taxpayer engaged in a manufacturing business may account for sales of his product when the goods are shipped, when the product is delivered or accepted, or when title to the goods passes to the customer, whether or not billed, depending upon the method regularly employed in keeping his books. Likewise, the extent to which indirect costs shall be included in computing cost of goods sold depends upon the method used by the taxpayer in treating such items in keeping his books.

* * *

§ 1.451-1. GENERAL RULE FOR TAXABLE YEAR OF INCLUSION —(a) *General rule.* Gains, profits, and income are to be included in gross income for the taxable year in which they are actually or constructively received by the taxpayer unless includible for a different year in accordance with the taxpayer's method of accounting. Under an ac-

crual method of accounting, income is includible in gross income when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. Therefore, under such a method of accounting if, in the case of compensation for services, no determination can be made as to the right to such compensation or the amount thereof until the services are completed, the amount of compensation is ordinarily income for the taxable year in which the determination can be made. Under the cash receipts and disbursements method of accounting, such an amount is includible in gross income when actually or constructively received. Where an amount of income is properly accrued on the basis of a reasonable estimate and the exact amount is subsequently determined, the difference, if any, shall be taken into account for the taxable year in which such determination is made. To the extent that income is attributable to the recovery of bad debts for accounts charged off in prior years, it is includible in the year of recovery in accordance with the taxpayer's method of accounting, regardless of the date when the amounts were charged off. For treatment of bad debts and bad debt recoveries, see sections 166 and 111 and the regulations thereunder. For rules relating to the treatment of amounts received in crop shares, see section 61 and the regulations thereunder. For the year in which a partner must include his distributive share of partnership income, see section 706(a) and paragraph (a) of § 1.706-1. If a taxpayer ascertains that an item should have been included in gross income in a prior taxable year, he should, if within the period of limitation, file an amended return and pay any additional tax due. Similarly, if a taxpayer ascertains that an item was improperly included in gross income in a prior taxable year, he should, if within the period of limitation, file claim for credit or refund of any overpayment of tax arising therefrom.

* * *

§ 1.801-4. LIFE INSURANCE RESERVES.—(a) *Life insurance reserves defined.* For purposes of part I, subchapter L, chapter 1 of the Code, the term "life insurance reserves" (as defined in section 801(b)) means those amounts—

(1) Which are computed or estimated on the basis of recognized mortality or morbidity tables and assumed rates of interest;

(2) Which are set aside to mature or liquidate, either by payment or reinsurance, future unaccrued claims arising from life insurance, annuity, and noncancellable health and accident insurance contracts (including life insurance or annuity contracts combined with noncancellable health and accident insurance) involving, at the time with respect to which the reserve is computed, life, health, or accident contingencies; and

(3) Which, except as otherwise provided by section 801(b)(2) and paragraphs (b) and (c) of this section, are required by law. For the meaning of the term "reserves required by law", see paragraph (b) of § 1.801-5.

For purposes of determining life insurance reserves, only those amounts shall be taken into account which must be reserved either by express statutory provisions or by rules and regulations of the insurance department of a State, Territory, or the District of Columbia when promulgated in the exercise of a power conferred by statute. Moreover, such amounts must actually be held by the company during the taxable year for which the reserve is claimed. However, reserves held by the company with respect to the net value of risks reinsured in other solvent companies (whether or not authorized) shall be deducted from the company's life insurance reserves. For example, if an ordinary life policy with a reserve of $100 is reinsured in another solvent company on a yearly renewable term basis, and the reserve on such yearly renewable term policy is $10, the reinsured company shall include $90 ($100 minus

$10) in determining its life insurance reserves. Generally, life insurance reserves, as in the case of level premium life insurance, are held to supplement the future premium receipts when the latter, alone, are insufficient to cover the increased risk in the later years. For examples of reserves which qualify as life insurance reserves, see paragraph (d) of this section. For examples of reserves which do not qualify as life insurance reserves, see pagaraph (e) of this section.

* * *

(f) *Adjustments to life insurance reserves.* In the event it is determined on the basis of the facts of a particular case that premiums deferred and uncollected and premiums due and unpaid are not properly accruable for the taxable year under section 809 and, accordingly, are not properly includible under assets (as defined in section 805(b)(4)) for the taxable year, appropriate reduction shall be made in the life insurance reserves. This reduction shall be made when the insurance company has calculated life insurance reserves on the assumption that the premiums on all policies are paid annually or that all premiums due on or prior to the date of the annual statement have been paid.

* * *

§ 1.801-5. TOTAL RESERVES.—(a) *Total reserves defined.* For purposes of section 801(a) and § 1.801-3, the term "total reserves" is defined in section 801(c) as the sum of—

(1) Life insurance reserves (as defined in section 801(b) and § 1.801-4),

(2) * * *

(3) * * *

. . . In determining total reserves, a company is permitted to make use of the highest aggregate reserve required by any State or Territory or the District of Columbia in which it transacts business, but the reserve must

have been actually held during the taxable year for which the reserve is claimed . . . .

(b) *Reserves required by law defined.* For purposes of part I, subchapter L, chapter 1 of the Code, the term "reserves required by law" means reserves which are required either by express statutory provisions or by rules and regulations of the insurance department of a State, Territory, or the District of Columbia when promulgated in the exercise of a power conferred by statute, and which are reported in the annual statement of the company and accepted by state regulatory authorities as held for the fulfillment of the claims of policyholders or beneficiaries.

* * *

§ 1.804-4. INVESTMENT YIELD OF A LIFE INSURANCE COMPANY.—(a) * * *

(b) *Deductions from gross investment income*—(1) *Investment expenses.* (i) Section 804(c)(1) provides for the deduction of investment expenses by a life insurance company in determining investment yield. "Investment expenses" are those expenses of the taxable year which are fairly chargeable against gross investment income. For example, investment expenses include salaries and expenses paid exclusively for work in looking after investments, and amounts expended for printing, stationery, postage, and stenographic work incident to the collection of interest. An itemized schedule of such expenses shall be attached to the return.

(ii) Any assignment of general expenses to the investment department of a life insurance company for which a deduction is claimed under section 804(c)(1) subjects the entire deduction for investment expenses to the limitation provided in that section and subdivision (iii) of this subparagraph. As used in section 804(c)(1), the term "general expenses" means any expense paid or incurred for the benefit of more than one department of the company rather than for the benefit of a particular department thereof. For example, if real estate taxes, depreciation,

or other expenses attributable to office space owned by the company and utilized by it in connection with its investment function are assigned to investment expenses, such items shall be deductible as general expenses assigned to or included in investment expenses and as such shall be subject to the limitation of section 804(c)(1) and subdivision (iii) of this subparagraph. Similarly, if an expense, such as a salary, is attributable to more than one department, including the investment department, such expense may be properly allocated among these departments. If such expenses are allocated, the amount properly allocable to the investment department shall be deductible as general expenses assigned to or included in investment expenses and as such shall be subject to the limitation of section 804(c)(1) and subdivision (iii) of this subparagraph. If general expenses are in part assigned to or included in investment expenses, the maximum allowance (as determined under section 804(c)(1)) shall not be granted unless it is shown to the satisfaction of the district director that such allowance is justified by a reasonable assignment of actual expenses. The accounting procedure employed is not conclusive as to whether any assignment has in fact been made. Investment expenses do not include Federal income and excess profits taxes, if any. In cases where the investment expenses allowable as deductions under section 804(c)(1) exceed the limitation contained therein, see section 809 (a)(9).

* * *

§ 1.805-5. *Adjusted Reserves Rates and Earnings Rates.*

(a) * * *

(4) *Assets*—(i) *Definition.* Section 805(b)(4) defines the term "assets" as meaning all assets of the life insurance company (including nonadmitted assets), other than real and personal property (excluding money) used by the life insurance company in carrying on an insurance trade or business. For purposes of the preceding sentence, the term "money" includes cash, currency, bank deposits (including time deposits) whether or not interest bearing,

share accounts in savings and loan associations, checks (whether or not certified), drafts, money orders, and any other item of similar nature. The following items are the only ones to be excluded from the term "assets" as being considered "used by the life insurance company in carrying on an insurance trade or business":

(*a*) The home office and branch office buildings (including land) owned and occupied by the life insurance company;

(*b*) Furniture and equipment owned by the life insurance company and used in the home office and branch office buildings occupied by the life insurance company;

(*c*) Supplies, stationery, and printed matter used in the operations conducted in the home office and branch office buildings occupied by the life insurance company where for tax purposes such items are inventoried; and

(*d*) Automobiles and other depreciable personal property used in connection with the operations conducted in the home office and branch office buildings occupied by the life insurance company.

However, if any item, or portion thereof, of property falls within one of the above-listed groups and also is an "investment asset" (an asset from which gross investment income, as defined in section 804(b), is derived), such item, or portion thereof, shall not be excluded from the term "assets". Any item, or portion thereof, excluded from the definition of the term "assets" shall not be taken into account in computing the denominator used in determining the current earnings rate under section 805(b)(2) and subparagraph (2) of this paragraph. Conversely, any item, or portion thereof, included in the term "assets" shall be taken into account in computing the denominator used in determining the current earnings rate.

(ii) *Illustration of principles.* The provisions of subdivision (i) of this subparagraph may be illustrated by the following examples:

Example (1). Included in the statement of assets of P, a life insurance company, are the following items: Bonds; stocks; mortgages; home office and branch office buildings owned and wholly occupied by the company; furniture and equipment owned by the company and used in the home office and branch office buildings occupied by the company; agents' debit balances; premiums deferred and uncollected and premiums due and unpaid; bank deposits (including time deposits); and share accounts in savings and loan associations. For purposes of section 805(b)(4) and this subparagraph, the home office and branch office buildings owned and wholly occupied by the company, and the furniture and equipment owned by the company and used by it in connection with the operations conducted in the home office and branch office buildings occupied by the company, shall be excluded from the term "assets" since such items are the only ones considered as being used by P in carrying on an insurance trade or business. Accordingly, since bonds, stocks, mortgages, agents' debit balances, premiums deferred and uncollected and premiums due and unpaid, bank deposits (including time deposits), and share accounts in savings and loan associations are not considered as being used by P in carrying on an insurance trade or business, they are included within the term "assets" and, therefore, shall be taken into account by P in determining its current earnings rate.

Example (2). M, a life insurance company, owns an eleven-story downtown home office building, the ground floor of which it rents to various tenants and the remaining ten floors of which are occupied by it in carrying on its insurance business and operating its investment department. Under the provisions of section 805(b)(4) and this subparagraph, the ten floors occupied by M in carrying on its insurance business and operating its investment department shall be excluded from the term "assets." However, the ground floor rented to various tenants is an "investment asset" and as such shall be included within the term

"assets" and, therefore, shall be taken into account by M in determining its current earnings rate.

* * * * *

§ 1.809-4. GROSS AMOUNT.—(a) *Items taken into account.* For purposes of determining gain or loss from operations under section 809(b)(1) and (2), respectively, section 809(c) specifies three categories of items which shall be taken into account. Such items are in addition to the life insurance company's share of the investment yield (as determined under section 809(a)(1) and paragraph (c) of § 1.809-2). The three categories of items taken into account are:

(1) *Premiums.* (i) The gross amount of all premiums and other consideration on insurance and annuity contracts (including contracts supplementary thereto); less return premiums and premiums and other consideration arising out of reinsurance ceded. The term "gross amount of all premiums" means the premiums and other consideration provided in the insurance or annuity contract. Thus, the amount to be taken into account shall be the total of the premiums and other consideration provided in the insurance or annuity contract without any deduction for commissions, return premiums, reinsurance, dividends to policyholders, dividends left on deposit with the company, discounts on premiums paid in advance, interest applied in reduction of premiums (whether or not required to be credited in reduction of premiums under the terms of the contract), or any other item of similar nature. Such term includes advance premiums, premiums deferred and uncollected and premiums due and unpaid, deposits, fees, assessments, and consideration in respect of assuming liabilities under contracts not issued by the taxpayer (such as a payment or transfer of property in an assumption reinsurance transaction as defined in paragraph (a)(7)(ii) of § 1.809-5). The term also includes amounts a life insurance company charges itself representing premiums with re-

spect to liability for insurance and annuity benefits for its employees (including full-time life insurance salesmen within the meaning of section 7701(a)(20)).

* * *

§ 1.818-2. ACCOUNTING PROVISIONS.—(a) *Method of accounting.* (1) Section 818(a)(1) provides the general rule that all computations entering into the determination of taxes imposed by part I, subchapter L, chapter 1 of the Code, shall be made under an accrual method of accounting. Thus, the over-all method of accounting for life insurance companies shall be the accrual method. Except as otherwise provided in part I, the term "accrual method" shall have the same meaning and application in section 818 as it does under section 446 (relating to general rule for methods of accounting) and the regulations thereunder. For general rules relating to the taxable year for inclusion of income and deduction of expenses under an accrual method of accounting, see sections 451 and 461 and the regulations thereunder.

(2) Section 818(a)(2) provides that, to the extent permitted under this section, a life insurance company's method of accounting may be a combination of the accrual method with any other method of accounting permitted by chapter 1 of the Internal Revenue Code of 1954, other than the cash receipts and disbursements method. Thus, section 818(a)(2) specifically prohibits the use by a life insurance company of the cash receipts and disbursements method either separately or in combination with a permissible method of accounting. The term "method of accounting" includes not only the over-all method of accounting of the taxpayer but also the accounting treatment of any item. For purposes of section 818(a)(2), a life insurance company may elect to compute its taxable income under an over-all method of accounting consisting of the accrual method combined with the special methods of accounting for particular items of income and expense provided under

other sections of chapter 1 of the Internal Revenue Code of 1954, other than the cash receipts and disbursements method. These methods of accounting for special items include the accounting treatment provided for depreciation (section 167), research and experimental expenditures (section 174), soil and water conservation expenditures (section 175), organizational expenditures (section 248), etc. In addition, a life insurance company may, where applicable, use the crop method of accounting (as provided in the regulations under sections 61 and 162), and the installment method of accounting for sales of realty and casual sales of personalty (as provided in section 453(b)). To the extent not inconsistent with the provisions of the Internal Revenue Code of 1954 or the regulations thereunder and the method of accounting adopted by the taxpayer pursuant to this section, all computations entering into the determination of taxes imposed by part I shall be made in a manner consistent with the manner required for purposes of the annual statement approved by the National Association of Insurance Commissioners.

* * *

§ 1.1502-14. STOCK, BONDS AND OTHER OBLIGATIONS OF MEMBERS.—(a) *Intercompany distributions with respect to stock*—(1) *Dividends.* A dividend distributed by one member to another member during a consolidated return year shall be eliminated. For purposes of this paragraph, the term "dividend" means a distribution which is described in section 301(c)(1) other than a distribution described in section 243(c)(1).

* * *

§ 1.1502-1A. PRIVILEGE OF MAKING CONSOLIDATED RETURNS.—

(a) Section 1501 gives to the corporations of an affiliated group the privilege of making a consolidated income tax return for the taxable year in lieu of separate returns. This privilege is given, however, upon the condition that all corporations which have been members of the affiliated

group at any time during the taxable year for which the return is made consent to the regulations under section 1502 applicable to such taxable year and any amendments thereof duly prescribed prior to the last day prescribed by law for the filing of the return; and the making of the consolidated return is considered as such consent.

* * *

(c) The last day prescribed by law for the filing of the return includes the last day of the period of any extension of time granted by the Commissioner.

(d) The tax liability of the members of the affiliated group for the taxable year involved will be determined in accordance with the provisions of the regulations to which consent is given and without regard to any changes of the rules therein prescribed made subsequent to the last day prescribed by law for the filing of the return for such year.

§ 1.1502-11A. CONSOLIDATED RETURNS FOR SUBSEQUENT YEARS.—(a) *Consolidated returns required for subsequent years.* If a consolidated return is made under section 1502 for any taxable year, a consolidated return must be made for each subsequent taxable year during which the affiliated group remains in existence unless (1) a corporation (other than a corporation created or organized, directly or indirectly, by a member of the group) has become a member of the group during such subsequent taxable year, or (2) subsequent to the exercise of the election to make consolidated returns, subtitle A of the Code to the extent applicable to corporations, or the regulations under section 1502 which have been consented to, have been amended and any such amendment is of a character which makes substantially less advantageous to affiliated groups as a class the continued filing of consolidated returns, regardless of the effective date of such amendment, or (3) the Commissioner, prior to the time of making the return, upon application made by the common parent corporation and for good cause shown, grants permission to change. For the pur-

pose of subparagraph (2) of this paragraph, the expiration of a provision shall be considered as an amendment to the Code made on the date of such expiration.

* * *

§ 1.1502-30A. COMPUTATION OF TAX.—(a) *General rule.* In the case of an affiliated group which makes, or is required to make, a consolidated return for any taxable year, the tax liability of each corporation for the period during such year that it was a member of such group shall be computed, subject to the provisions of paragraph (b) of this section, upon the consolidated taxable income and the consolidated taxable income plus the aggregate of the deductions of the several affiliated corporations allowable under section 242, or, in the case of the taxes imposed by section 531, section 541 (except as provided in paragraph (b)(4) of this section), and section 802, upon the consolidated accumulated taxable income, the consolidated undistributed personal holding company income, the consolidated life insurance company taxable income, the consolidated life insurance company taxable income plus the aggregate of the deductions of the several affiliated corporations allowable under section 242, or the consolidated 1954 life insurance company taxable income, as the case may be, determined in each case in accordance with the regulations under section 1502. In the case of an affiliated group realizing long-term capital gains and computing its tax under the alternative tax provisions of section 1201, the tax shall be computed with reference to the consolidated taxable income, and the excess of the consolidated net long-term capital gain over the consolidated net short-term capital loss. The tax imposed under section 11(c) or section 831 shall be increased for any taxable year for which an affiliated group makes or is required to make a consolidated return by 2 percent of the consolidated taxable income (computed without regard to the deduction, if any, provided in section 242 for partially tax-exempt interest).

* * *

SEC. 1.1502-31A. BASES OF TAX COMPUTATION.—

* * *

(a) *Definitions.*—

* * *

(32) *Consolidated reserve interest credit.* The consolidated reserve interest credit shall be the aggregate of the reserve interest credits of the several members of the affiliated group.

* * *

(b) *Computations.* In the case of affiliated corporations which make, or are required to make, a consolidated return, and except as otherwise provided in the regulations under section 1502:

(1) *Taxable income.* The taxable income of each corporation shall be computed in accordance with the provisions covering the determination of taxable income of separate corporations, except:

(i) There shall be eliminated unrealized profits and losses in transactions between members of the affiliated group and dividend distributions from one member of the group to another member of the group (referred to in the regulations under section 1502 as intercompany transactions);

* * *